CLERK'S COPY.

192

744458
Supr. Ct

TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1946

No. 209

ADAM A. ADAMS, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR CERTIORARI FILED JUNE 18, 1946.

CERTIORARI GRANTED OCTOBER 14, 1946.

Office - Supreme Court, U. S.
FILED
JUN 18 1946
CHARLES ELMORE CROPLEY

IN THE

United States Circuit Court of Appeals

FOR THE THIRD CIRCUIT.

No. 9069.

ADAM A. ADAMS,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON APPEAL FROM DECISION OF THE TAX COURT OF THE UNITED STATES.

APPENDIX TO PETITIONER'S BRIEF AND PROCEEDINGS IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

SYDNEY A GUTKIN,
Attorney for and of Counsel with Petitioner,
744 Broad Street,
Newark 2, New Jersey.

Arthur W. Cross, Inc., Law Printers, 71-73 Clinton Street, Newark 5, N. J.

INDEX

	PAGE
Docket Entries	1a
Testimony	3a
Opinion	83a
Opinion	95a
Decision	111a

WITNESSES FOR PETITIONER.

Kurt M. Sinner,	
Direct	7a
Cross	19a
Re-direct	28a, 31a
Re-cross	30a
Adam A. Adams,	
Direct	31a
Cross	35a
Recalled,	
Direct	57a
Cross	58a
Charles F. Kramer,	
Direct	37a
Cross	50a
Re-direct	56a

EXHIBITS.

	Admitted at Page	Printed at Page
P-1—Certificate of Incorporation	8a	
P-2—Minutes of two meetings of Board of Directors and Stockholders of the Newark Theatre Building Corporation	9a	62a
P-3—$100 Par Value Certificates of Capital Stock of the Newark Theatre Building Corporation	11a	
P-4—Certificate	12a	69a
P-5—Bonds	12a	70a
P-6—Certificate of Decrease of Capital Stock	17a	72a
P-7—Balance Sheets	18a	79a
P-8—Balance Sheet	18a	81a
P-9—Photographs	42a	
P-10—Picture	49a	
R-A—Protest	37a	
R-B—Lease	56a	
R-C—Gift Tax Return	60a	
R-E to S—Returns	61a	

Proceedings in the United States Circuit Court of Appeals for the Third Circuit 112a

Order 113a

Opinion of the Court 114a

Judgment 118a

Certificate 119a

Order Allowing Certiorari 119

APPENDIX.

Docket Entries.

1944

Feb.	24.	Petition received and filed. Taxpayer notified. Fee paid.
"	24.	Copy of petition served on General Counsel.
"	24.	Request for Circuit hearing in New York, N. Y., filed by taxpayer. 2/28/44 granted.
Apr.	7.	Answer filed by General Counsel.
"	13.	Copy of answer served on taxpayer. New York City.
Aug.	12.	Hearing set Oct. 2, 1944 at New York.
Oct.	5.	Hearing had before Judge Kern on merits. Briefs due 12/4/44. Replies 12/19/44.
"	9.	Amendment to petition filed by taxpayer. Copy served 10/11/44.
"	25.	Transcript of hearing of 10/5/44 filed.
Dec.	1.	Answer to the amendment to petition filed by General Counsel. Copy served 12/2/44.
"	4.	Brief filed by taxpayer.
"	4.	Motion for extension to Dec. 19, 1944 to file brief filed by General Counsel. 12/5/44 granted.
"	20.	Motion for leave to file the attached brief, brief lodged filed by General Counsel. 12/21/44 granted.
"	22.	Copy of brief served on General Counsel.

1945

Jan.	4.	Motion for extension to Jan. 18, 1945 to file reply brief filed by taxpayer. 1/5/45 granted.
"	4.	Motion for extension to Jan. 22, 1945 to file reply brief filed by General Counsel. 1/5/45 granted.

Docket Entries.

1945

Jan. 17. Reply brief filed by taxpayer. 1/17/45 copy served.

" 22. Reply brief filed by General Counsel. Copy served 1/23/45.

Apr. 26. Findings of fact and opinion rendered Kern J. Decision will be entered under Rule 50. Copies served 4/26/45.

May 1. Order directing the report of Div. 16 promulgated April 26, 1945 be reviewed by the Court entered. Murdock J.

June 29. Findings of fact and opinion rendered Opper J. Decision will be entered for the respondent. 6/29/45 copy served.

" 29. Decision entered Opper J. Div. 14.

Sept. 6. Petition for review by U. S. Circuit Court of Appeals, Third Circuit, filed by taxpayer.

" 7. Notice of filing petition for review sent to J. P. Wenchel filed.

" 7. Proof of service filed.

" 17. Designation of record filed by taxpayer.

" 24. Proof of service of designation of record filed.

Oct. 4. Motion for extension to 11/16/45 to prepare, transmit and deliver the record filed by taxpayer.

" 4. Order extending time to 12/5/45 to prepare, transmit and deliver the record entered.

(Page 1)

Testimony.

Room 5050, 70 East 45th Street,
New York, N. Y,
October 5, 1944 at 2 P. M.

(Met pursuant to notice.)

Before: HONORABLE JOHN W. KERN, Judge.

Appearances:

SYDNEY A. GUTKIN, ESQ., for the Petitioner, 744 Broad Street, Newark, N. J.

JONAS M. SMITH, ESQ. (HONORABLE J. P. WENCHEL, Chief Counsel, Bureau of Internal Revenue), appearing on behalf of the COMMISSIONER OF INTERNAL REVENUE, Respondent.

(Page 2) PROCEEDINGS.

The Court: May I have an opening statement?

Mr. Gutkin: Yes, may it please the Court, the issue in this case, the main issue is comparatively a simple issue. This involves primarily the question of whether or not a recapitalization of the Newark Theatre Building Corporation, a corporation of New Jersey, falls within Section 112B of the Internal Revenue code. During the year 1940, in the month of December in that year, the Newark Theatre Building Corporation for a business purpose necessary in the connection with the affairs of the corporation determined to recapitalize by taking all of the common stock which was $100 par value common stock, the only stock issued as outstanding, cancelling that stock and in place of it issuing no par value common stock and $50 debenture bonds.

Proceedings of October 5, 1944.

Pursuant to the plan of recapitalization, the old common stock was turned in by the stockholders, new common stock and bonds were issued to replace the old common stock. We submit that that transaction was a tax free exchange under Section 112B of Internal Revenue code. This Court has held that it is under exactly similar circumstances as the Docerty case. A secondary issue depending upon whether or not the Court finds that there is not a non-taxable exchange centers around the possibility of so finding, although we submit that there (Page 3) is no probability in the light of the Docerty case. In other words, we submit that if the exchange is a taxable exchange and not governed by Section 112B, that instead of being an exchange upon which gain is recognized, it is an exchange which resulted in a loss, because the fair value of the assets received upon the exchange is less than the cost basis of the stock held by this taxpayer.

In other words, the cost basis of the stock of this taxpayer in the Newark Theatre Building Corporation, which was exchanged for the new stock and bonds is approximately $418,000. The fair value of the property received in exchange for the new stock and the bonds together had a value of between $200,000 and $300,000, so that rather than a gain upon the exchange a loss was incurred.

We also submit that the earnings of profits of the company were not sufficient to result in the amount of dividend that the Commissioner alleges this taxpayer received. There is an error in the computation of the earnings and profits account of the corporation, comparatively slight, but nevertheless to the extent of some $7.000 or so. We submit that under the adjudicated cases of this Court there is no tax to be paid upon the exchange, no gain or loss was recognized, that there was no dividend declared by the corporation and that there should be a decision for the petitioner in accordance with it.

Proceedings of October 5, 1944.

(Page 4) The Court: Mr. Smith.

Mr. Smith: If Your Honor please, respondent contends in this case that the transaction herein did not come within the terms of Section 112B or 112G that what happened was the petitioner in fact received the dividends in the amount of the earnings of the profits that accumulated up to the time that this transaction took place, that debentures which were received were in fact dividends and not a part of the exchange of this transaction and subject to tax to the extent of the value of the accumulated earnings and profits up to the time of this year which is in 1941. We also think that the petitioner in fact did receive a different interest than he had before in view of the fact that after the exchange of stocks for stock he had the debentures of which he could [illegible]est himself at any time he wished and at the same time he would still have all the assets of the corporation as he had before, I mean, since he had practically all the stock, he had practically the entire control of the corporation just as he did before.

I believe that we neglected to mention the fact that the petitioner here owned practically all of the stock of the corporation with the exception of a few shares which I think was owned by his family, therefore, it enured to his benefit. Now, we say also there was no business interest connected with this transaction, that in order for (Page 5) him to meet the requirements of the statute, he must show that there was a business interest in this transaction and we say that there was no such interest in the way we see the case at this time.

Now, with reference to the secondary issues talked about, of course that would be subject to proof as to what the stock of this company was. That respondent has no knowledge at this time except that he believes in accordance with the balance sheets of the corporation that the value of the stock was far in excess instead of below the

amount received by the petitioner. As far as the earnings of profits issue is concerned, petitioner does not seem to have made such an issue in his petition. He cites an alternative issue, but states that the dividend, that is the amount the respondent set up, $164,000., that that dividend really had no value. I take it he means by that it had no value because the stock was in excess of the value of the assets that were received when this transaction took place and I don't see that he has put in issue the fact that accumulated earnings and profits were not in the amount of $164,000. and some odd dollars. I shall of course make my objection to any testimony along that line since as I see it, is not at issue and I am not making that statement at this time so that the petitioner will be put on notice.

The Court: Thank you, suppose we get this matter (Page 6) of the pleadings straightened out first. Upon what allegations of the petition does the petitioner rely on that third issue that was mentioned, Paragraph 4-D at the bottom of Page 2?

Mr. Gutkin: I think, Your Honor, that that would be covered by 4-D on the bottom of Page 2, but I think that if there should be any possibility of any question that it is not covered I should like to make a motion to amend at this time to raise that issue and will submit an amendment in writing.

The Court: You see that paragraph reads in the first phrase, "Also in the alternative, the Commissioner erred in holding that the amount of the dividend, if any, derived through the exchange was in the amount of $164,000. or any value."

Mr. Gutkin: Exactly, sir.

The Court: I take it that the Commissioner has determined that it was in the amount of $164,000.

Mr. Smith: Correct, Your Honor.

Kurt M. Sinner, for Petitioner—Direct.

The Court, Now, petitioner says that the Commissioner erred in determining that it was $164,000. and also alleges that the Commissioner erred in determining that it had any value.

Mr. Smith: That's right.

The Court: So would not the amount of that (Page 7) dividend be an issue under that phrase?

Mr. Smith: It would be an issue as I see it as to a question of value but not as to a question of accumulated earnings and profits. In other words, it seems to me it is tied up with E. The way I read it, the alternative here talking about as two alternatives are the same alternative. It seems to me to be quite ambiguous in that respect.

The Court: Perhaps it would be well for the Petitioner to file an amended petition getting it out a little plainer. I can see if we labor hard we might be able to make an issue here but I think it would be well to have an amended petition.

Mr. Gutkin: Yes, your Honor, I discussed this very thing with Mr. Smith a week or so ago and it is not too great an amount anyway.

The Court: I understand that there are no stipulations of fact.

Mr. Gutkin: No, your Honor, I think on the main issue it will just take a few moments to prove it.

The Court: All right, call your first witness. Whereupon,

KURT M. SINNER, called as a witness on behalf of the petitioner, after having been duly sworn, testified as follows:

(Page 8) *Direct examination by Mr. Gutkin:*

Q. What is your full name? A. Kurt M. Sinner.

Kurt M. Sinner, for Petitioner—Direct.

Q. Where do you reside? A. 1012 Beaver Street, Newark, N. J.

Mr. Gutkin: With the consent of counsel for the respondent I should like to offer in evidence a certified copy of the original certificate of incorporation of the Newark Theatre Building Corporation.

The Court: Accept it into evidence.

(Certified copy of original certificate of incorporation received in evidence and marked Petitioner's Exhibit 1.)

Q. Mr. Sinner, you are a certified public accountant of the State of New Jersey, are you not? A. Yes, sir.

Q. You are the accountant for the Newark Theatre Building Corporation? A. Yes, sir.

Q. And for Mr. Adam A. Adams, petitioner in this cause? A. Yes, sir.

Q. Are you personally acquainted with the events that led up to the redemption of thirty stocks of the Newark Theatre Building Corporation and the issuance of (Page 9) new stock and bonds to replace the old stock? A. Yes, sir.

Q. Were you present at a meeting of the Board of Directors and a meeting of the stockholders of the Newark Theatre Building Corporation on December 6, 1940? A. Yes, sir.

Q. At those meetings was a plan for the recapitalization of the Newark Theatre Building Corporation adopted? A. Yes, sir.

Q. I show you minutes of meeting of Board of Directors of the Newark Theatre Building Corporation, dated December 6, 1940, a waiver of notice of meeting of stockholders of the same corporation, dated the same date and minutes of a special meeting of stockholders of the same

corporation, held on the same date and ask whether these are the original minutes of meetings of the Board of Directors and stockholders of the Newark Theatre Building Corporation, held on December 6, 1940? A. They are.

Mr. Gutkin: With your Honor's permission and with the consent of counsel for the respondent, I should like to offer the minutes of the two meetings in evidence and to substitute for the same a photostatic copy thereof.

Mr. Smith: No objection.

The Court: Accept it into evidence as petitioner's (Page 10) Exhibit 2 and leave granted.

(Minutes received in evidence and marked Petitioner's Exhibit 2 in evidence.)

Q. Mr. Sinner, these meetings of directors and stockholders of the Newark Theatre Building Corporation were the result of certain discussions with respect to a proposed recapitalization of the company, were they not? A. Yes, sir.

Q. You were greatly instrumental in the carrying out of that plan, recapitalization, were you not? A. I was.

Q. You were present at all discussions with respect to the same, were you not? A. Yes, sir.

Q. Would you state what the reasons were for the proposed recapitalization as you know them today? A. Well, there were a number of reasons. One of the first and most pressing reason was that the company was thinking and had been attempting to recapitalize its indebtedness. A mortgage that was on the building 193, 195 Market Street and Beaver Street were originally contracted when Mr. Adam A. Adams and Mr. Peter Adams personally had titles and both Mr. Peter Adams and Mr. Adam A. Adams were on the bond. After the separation of interests between Mr.

Peter Adams and Mr. Adam A. Adams, (Page 11) in 1939, Mr. Peter Adams had repeatedly requested that he be taken off the bond, in other words, that his liability on the bond be taken off. However, the mortgagee would not——

Mr. Smith: Were you present when Mr. Peter Adams made that request you are talking of?

The Witness: I beg your pardon?

Mr. Smith: Are you talking about what someone else said?

The Witness: No, I was there.

Mr. Smith: You were there?

The Witness: Yes.

Q. Will you continue, please? A. Mr. Adam A. Adams had prior to this time attempted a number of times to negotiate a new loan. He had not been successful. We thought at the time that an additional collateral might be required and that it might be easier to place as collateral for loans a ceiling or number of debentures or an instrument of obligation rather than the common stock of the company which in itself nobody seemed to want to take as collateral.

Q. When you speak of, we thought that we would be able to use bonds more easily than stock, do you refer to the corporation or any of the individuals? A. The directors of the corporation and myself. I was there at all the discussions. I entered into them. (Page 12) I am not a stockholder, but being the accountant of the company, I was naturally consulted in these matters.

Q. And the directors acting on behalf of any of the individuals or acting on behalf of the corporation? A. On behalf of the corporation. A secondary consideration, there was the capital structure which had outstanding 5,914 par value shares and by reducing that under the New Jersey franchise taxes we would have $400 and some odd dollars

per year. That was one of the factors that I took into consideration.

Q. Were there any other reasons? A. Yes, there would also be income tax savings in doing this.

Q. I show you certain papers which purport to be shares of capital stock of the Newark Theatre Building Corporation, stating that it has a capital stock of $600,000, the certificate having a stamp on it that the shares are $100 each and ask whether these are the certificates formerly held by the stockholders of the corporation prior to the reorganization of the corporation? A. They are sir.

Mr. Gutkin: With consent of counsel for the respondent, I wish to offer in evidence the $100 par value certificates of capital stock of the Newark Theatre Building Corporation which had been redeemed by the stockholders (Page 13) thereof.

The Court: Let it be received in evidence.

Certificates received in evidence and marked Petitioner's Exhibit No. 3 in evidence.)

Q. Referring to the plan of reorganization, what did the plan require that the stockholders do? A. I know what the plan was.

Q. You may state it if you don't need anything to refresh your recollection? A. It required the stockholders to turn in their certificates of $100 par value in exchange for a certificate no par value with a stated value of $50 and a debenture of $50.

Q. According to the books of the corporation, how many shares of $100 par value stock were held by Mr. Adam A. Adams in December, 1940, upon the adoption of the plan of reorganization? A. 5,903.

Q. What did Mr. Adams do with these shares if you know of your own knowledge? A. Yes, he brought in his shares in my office and I issued to him and to the other

stockholders new certificates, that is, I wrote them out and they were signed by the proper officer, new certificates and debentures of the type called for. This was on January 27, 1941.

(Page 14) Q. Was the plan carried out in exact accordance with the terms? A. Yes, sir.

Mr. Gutkin: With consent of counsel for the respondent I offer in evidence a certificate numbers 3, 4, 5, 903 shares* of the Newark Theatre Building Corporation, issued to Adam A. Adams, bearing date January 27, 1941, and ask your Honor's permission to withdraw the same and to substitute in place thereof photostatic copy.

The Court: Let it be received in evidence, leave granted.

(Certificate received in evidence and marked Petitioner's Exhibit No. 4 in evidence.)

Mr. Gutkin: Also with consent of counsel for the respondent I offer in evidence one of the bonds issued to Mr. Adam A. Adams in accordance with the plan of liquidation for the purpose of indicating that the type of bond that was issued in connection with the plan and ask leave to withdraw the same and substitute a photostatic copy thereof.

The Court: Admitted in evidence and leave granted.

(Bonds received in evidence and marked Petitioner's Exhibit 5 in evidence.)

Q. Mr. Sinner, have you made an analysis of the (Page 15) surplus or the earnings of profits account of the Newark Theatre Building Corporation as it was on January 27, 1941? A. Yes, sir.

---

*Corrected: certificate number 3 for 5903 shares.

Kurt M. Sinner, for Petitioner—Direct.

Q. Were the books and records of the corporation kept under your supervision and control? A. Yes, sir.

Q. You are familiar with the books and records of the corporation? A. Yes, sir, I am.

Q. You have them in court with you? A. Yes, sir.

Q. Have you any paper which you might use to refresh your recollection with respect to the earnings or profit accounts, so that we might be able to expedite the development of the accumulated earnings or profits of the corporation? A. Yes, sir.

Q. Referring to the records of the corporation, will you state what the earnings or profits of the corporation accumulated as of January 27, 1941?

Mr. Smith: I object to that, that is a conclusion. If he is going to find out what that is he has to go through that right from the beginning right up to what it was and I object to his stating what it was as a conclusion.

The Court: Is this question as to what the books show it to have been?

(Page 16) Mr. Gutkin: Yes, your Honor.

The Court: I will overrule the objection, he can answer. What do the books show the earnings or profits to have been?

The Witness: On January 2, 1941, the accumulated earnings or profits in the surplus account show $45,629.05.

Q. In the history of the corporation there had been some earnings or profits that had been capitalized in prior years? A. Yes, sir.

Q. What was the amount of earnings or profits that you had capitalized in prior years? A. $111,596.

Kurt M. Sinner, for Petitioner—Direct.

Q. Now, Mr. Sinner, referring to the books and records which might indicate what Mr. Adams' cost basis for his stock of the corporation was, would you take those books and records and develop for us Mr. Adams' cost basis of his stock? A. Prior to January 1, 1928, Mr. Adam A. Adams and Mr. Peter Adams operated two theatres, one in Paterson, N. J. and one in Newark, N. J. and also owned other realty, all of which was carried on as partners.

On January 1, 1928, there were formed five corporations, the Newark Theatre Building Corporation, which acquired from the partners the theatre building and sundry (Page 17) other assets; the Alpha Pi Realty Corporation, which acquired certain other commercial buildings in Newark; The Newark Theatre Amusement Corporation; which acquired title to the fixtures in the theatre; the U. S. Theatre Corporation which acquired title to the theatre building in Patterson and the lease to the land and operated the U. S. Theatre and the Adams Brothers Realty Corporation, which acquired the other commercial buildings in the City of Patterson, the partners being even. Their holdings with the exception of qualifying shares were equally split on date of incorporation.

Now, those costs, I have gone through the old records, those costs I have determined several years ago. It was necessary for me to find out about those things and several years ago I made an analysis. I have some sheets with me that I made up at that time,

Q. If they will refresh your recollection you may refer to them and testify therefrom.

Mr. Smith: Now, if your Honor please, I object to his testifying as to what the cost was from any sheets he may have.

The Court: While looking at this memorandum you are able to follow through step by step your calculations and tell the Court?

The Witness: Yes.

(Page 18) The Court: The question is not to give one final sum, but you are going to get from this witness the various steps he took working from the books?

Mr. Gutkin: Yes, we have the books present and I wish the record would show Mr. Sinner is referring to those books where necessary.

Mr. Smith: You overrule my objection, I take it?

The Court: Yes.

Mr. Smith: I take an exception.

The Court: Exception noted.

Q. These are the books of original entry, are they not? A. Yes, these are the books of the various companies involved.

Q. In the statement you just made? A. Yes.

Q. And are they books of original entry kept in the ordinary course of business of the various companies and concerns that you mentioned? A. Yes, sir.

Q. And these sheets that you are referring to to refresh your recollection are sheets made up by referring to these books? A. They were made up by me by going through these books, yes, sir.

(Page 19) Q. And they are in exact accord with the books? A. Yes, sir.

Mr. Smith: What books are those that you are referring to?

The Witness: Of all the various companies that I mentioned.

Mr. Smith: And are you also referring to the books of the partnership, did they have books?

The Witness: Yes, sir, they are here too.

The Court: Go ahead, sir.

Kurt M. Sinner, for Petitioner—Direct.

Q. Would you kindly continue with your development of the cost basis and give each item thereof and then try to arrive at a total cost basis for all of the stock held by Mr. Adams at the date of the adoption of the plan of recapitalization and when he exchanged his old stock for new stock and bonds? A. The amount that was transferred from the Patterson partnership to the corporations that were operating in Patterson, Mr. Adam A. Adams' share was $207,547.82. In the three Newark corporations, the investment at cost as determined by me was $192,379.97. That includes, however the cost of all the shares issued for Mr. Adam A. Adams. In addition thereto, there was issued in the U. S. Theatre Amusement Corporation during 1928 fifteen shares for which Mr. Adam A. Adams had invested cash. During the (Page 20) year, I think it is 1931, on audit by the Internal Revenue Department, of both the Newark and Patterson properties, the revenue agents made certain adjustment to the depreciation as basis of cost for years prior to December 31, 1927 as a result of which the corrections as of January 31, 1928, involved $1,822.72 in Patterson, in the U. S. Theatre and $8,656.88 in Newark. That is Mr. Adam A. Adams' portion of the adjustment. Subsequently, when the Newark Theatre Amusement Company went out of existence in 1931, the two Adams brothers had cash loans there which they never got back, which is an additional investment. Mr. Adam A. Adams' sum is $6,812.50. That would give us a total cost of $418,719.09 for the final 5,914 shares. However, on the date of January 27, 1941, Mr. Adam A. Adams held 5,903, so if I take a fraction of that that makes the cost of the 5,903 shares $417,944.28, to which must be added the four dollars which he paid in 1938 for a fractional part of a share upon the issuance of the last stock dividend. Now, I just stated that there were formed five corporations in 1928. In 1932, due to a series of non-taxable stock exchanges, the

company, filed consolidated returns. In 1935, Mr. Peter Adams and Mr. Adam A. Adams wanted to separate their interests and Mr. Peter Adams took the Patterson companies and Mr. Adam A. Adams took the Newark companies. Subsequent to that in 1936, one of the Newark companies was (Page 21) not in existence then, the Newark Theatre Amusement Corp. In 1936, the properties of the Alpha Pi Realty Company were sold at cost to the Newark Theatre Amusement Corporation, so therefore all of Mr. Adams' holdings are now vested in the Newark Theatre Building Corporation, the cost of which still remains the same as it was in 1927, with the exception of the additions that I have mentioned.

Q. The total amount that you mentioned does that represent the interest to Mr. Adam A. Adams of his 5,903 shares of $100 par value stock of the Newark Theatre building Corporation? A. Yes, sir.

Q. And that amount would you repeat? A. $417,944.28.

Mr. Gutkin: With consent of counsel for the respondent I offer in evidence a certified copy of a certificate of decrease of capital stock and amendment of the certificate of incorporation of the Newark Theatre Building Corporation, pursuant to the plan of reorganization thereof.

The Court: Which will be received.

(Certified copy of certificate of decrease of capital stock and amendment of certificate of incorporation received in evidence and marked petitioner's Exhibit 6 in evidence.)

(Page 22) Q. Mr. Sinner, I show you a paper which purports to be the balance sheet of the Newark Theatre Building Corporation as at December 31, 1940, and ask whether you prepared the same and whether this is a true

and correct balance sheet of the assets and liabilities of that corporation as of that date? A. It is.

Mr. Gutkin: I ask your Honor that it be marked in evidence.

The Court: No objection?

Mr. Smith: Are these the balance sheets?

Mr. Gutkin: Yes, sir.

Mr. Smith: Are these made up by you from the books?

The Witness: Yes, sir.

Mr. Smith: No objection.

The Court: Accept that in evidence.

(Balance sheets received in evidence and marked Petitioner's Exhibit No. 7 in evidence.)

Q. I show you a paper which purports to be the balance sheet of the Newark Theatre Building Corporation, as of December 31, 1941, and ask whether or not you prepared the same and whether it shows the assets and liabilities of the corporation as of that date? (Page 23). A. Yes.

Mr. Gutkin: I ask that it be marked in evidence.

Mr. Smith: No objection.

The Court: Accept that in evidence.

(Balance sheet received in evidence and marked Petitioner's Exhibit No. 8 in evidence.)

Q. Referring to the books and records of the corporation, the Newark Theatre Building Corporation, how was the exchange pursuant to the plan treated on the books with respect to the capital and surplus account? A. The surplus was not affected at all. We debited the old par capital stock for the sum of $591,400. and credited the new no par value stock of $295,700. and credited the rest to an obligation or indebtedness called debentures $295,700.

Kurt M. Sinner, for Petitioner—Cross.

Q. As a result of the exchange did you make any entries or changes with respect to the surplus account? A. No, sir, there was not any intent to take anything out of surplus.

Q. At the time the plan of reorganization was discussed, was there any intent or purpose to declare a dividend? A. No, sir.

Mr. Gutkin: You may cross examine.

(Page 24) *Cross examination by Mr. Smith:*

Q. Mr. Sinner, I believe you stated on direct examination that the purpose of exchanging the 5,000, whatever number it was, 5,903 shares of stock of $100 par value for no par value of stock and for debentures was because there was a number of loans outstanding? A. No, an open mortgage outstanding.

Q. An open mortgage? A. Yes, sir.

Q. And what did you propose to accomplish by that? A. Well, the thought in mind was that if the mortgage itself would not give sufficient security, we might have to borrow money, whether Mr. Adams borrowed it personally or whether the corporation could borrow it and give therefore as collateral either stock or debentures, and we thought it would be easier to borrow on the strength of debentures rather than on the strength of common stock.

Q. What was the basis for that? A. I don't follow that.

Q. What was the basis for thinking that debentures were easier to borrow on than stock? A. Well, that was the thought we had.

Q. You mean by "we" you are talking about now, the Newark Theatre Building Corporation, that is the stock we are talking about? (Page 25) A. Yes.

Q. So that when you refer to "we" you mean that? A. I mean their directors and myself.

Q. Well, in your minutes you state that the whole capital structure of the company was not well balanced and it was not sound business to have some topheavy capital setup? A. Yes.

Q. You also stated that your purpose was to save about $400 in franchise taxes? A. Yes.

Q. How much did it cost to make this transfer over, how many fees were paid by the corporation? A. I can identify the bills right here. There is a bill paid early in that year, February 5th, $170.30 and there is another one paid in June.

Q. Who acted as attorney in this transaction, do you know? A. Yes, sir.

Q. Who was that? A. The office of Arthur T. Vanderbilt, Newark.

Q. And how much did he charge, how much was paid to him during that year as fees?

Mr. Gutkin: With respect to this transaction of course?

(Page 26) Mr. Smith: That's correct.

Mr. Witness: On February 5th, $170.30 and on June 12th, $589.14.

Q. That was all that was paid? A. Yes, sir.

Q. Now, you also stated that one of the purposes was the saving of income taxes, did you not? A. Yes, sir.

Q. Wasn't that the principal purpose? A. No, it was not the principal purpose.

Q. Well, as a matter of fact you saved a great deal more in income taxes than you did in franchise taxes? A. Yes.

Q. How much did you save in income taxes that one year? A. I haven't made a calculation as to that.

Kurt M. Sinner, for Petitioner—Cross.

Q. You don't know as to that? A. I don't know but I could make a calculation.

Q. Now, as a result of having debentures in place of stock, you of course were able to deduct interest that you were not able to deduct before? A. Yes.

Q. So that as to that extent there was a saving in income taxes? A. Yes.

(Page 27) Q. And whatever that saving was in 1941, 1942 and 1943, would be a part of the savings here in income taxes? A. I didn't follow that.

Q. Whatever the interest that was deducted for these bonds in 1941, 1942 and 1943, would be part of the savings for these years, if not all, would it not, for the corporation? A. Yes, sir.

Q. And then do you know whether or not the debentures were ever made as gifts by Mr. Adam A. Adams, the Petitioner here, to his children? A. I do, sir.

Q. Wasn't that one of the reasons for this transaction in order to make these gifts? A. I know that, this has nothing to do with the corporation but I will give you the answer. I know that Mr. Adams has it in mind or had it in mind to give some of his certificates and debentures and otherwise to give it to members of his family as they were growing older.

Q. Now, you have very rapidly come to the conclusion that the cost of this stock 5,093 shares* of the Newark Theatre Building Corporation was $417,904.28 to this petitioner? A. $417,944.28.

Q. And you have done that by rapid calculation? (Page 28) A. I didn't do it here.

Q. But that is the figure you have given us? A. That is the final figure I arrived at, yes.

Q. This corporation was founded when, January 1, 1928? A. Yes, sir.

---

* Corrected: 5903 shares.

Kurt M. Sinnyr, for Petitioner—Cross.

Q. At that time, how many shares of stock did the petitioner, that is, Mr. Adam A. Adams acquire of the Newark Theatre Building Corporation? A. 1,000 shares.

Q. 1,000 shares? A. Yes, sir.

Q. Of this stock the 1,000 shares were acquired on January 1, 1928 for him? A. Yes, sir.

Q. Now, what was that acquired for, what was given for that stock? I mean, what was that stock for, in lieu of what? A. The building that belonged to the partnership.

Q. The building that belonged to the partnership? A. That's correct.

Q. Now, when did the partnership acquire the building? A. I think it was in 1921.

Q. And how much did the partnership pay for the building? (Page 29) A. Land and building $937,000.

Q. $937,000? A. Yes, sir.

Q. And that is what was acquired by that corporation? A. Yes.

Q. Now, how many shares of stock was issued by the corporation on January 21, 1928? A. 2,000 shares.

Q. 2,000 shares? A. Yes, sir.

Q. Now, who received the other 1,000 shares? A. Mr. Peter Adams.

Q. Mr. Peter Adams? A. Yes.

Q. Now, was there not 5,000 shares issued on January 21, 1928? A. No, sir, it was not only the building, there are cash supplies and other stuff transferred here too.

Q. Well, I show you what purports to be the 1928 income tax return of the Newark Theatre Building Corporation for 1928 and you will note on here it says, 500,000, wouldn't that show that 500,000 shares of stock were issued? A. You are right, I was testifying from the books of Newark Theatre Amusement Corporation.

Q. In other words, you were not testifying from the (Page 30) correct books? A. That's right.

Kurt M. Sinner, for Petitioner—Cross.

Q. So then let us get this straight now, how many shares of stock were issued to Adam A. Adams on January 1, 1928 on the Newark Theatre Building Corporation stock, which is the stock we have in issue here? A. 2,500.

Q. 2,500 were issued to him? A. Yes.

Q. And that was one-half of the total issue? A. Yes, sir.

Q. Now, when were the next shares issued to Mr. Adam A. Adams, the next shares of the Newark Theatre Building Corporation? A. The next thing that happened was on January 31, 1932, there were 628 shares of Mr. Adam A. Adams' stock cancelled and put back into treasury stock in order to take off the books the appreciation that had been placed hereon on date of incorporation.

Q. How many shares were taken off? A. 628.

Q. 628 of this gentleman? A. 628 of Mr. Adam A. Adams and the same amount from Mr. Peter Adams.

Q. So that left him on January 1, 1933, with how (Page 31) many shares? A. He had 1,872 shares.

Q. Well, he only had 2,500 in the first place and you say 628 off? A. That's right.

Q. Now, when were the next shares issued? A. On January 9, 1932, there were issued 383 shares in exchange for the same number of shares of Newark Theatre Amusement Company stock.

Q. In exchange for Newark Theatre Amusement Company? A. That's right, on the same date——

Q. This is to Adam A. Adams, the petitioner? A. Yes.

Q. All right, go ahead. A. On the same date, 1,400 shares were exchanged for 2,800 shares of Newark Theatre Amusement Corporation.

Q. He acquired 1,400 more for what? A. For 2,800 shares of Newark Theatre Amusement Corporation.

Q. Well now, in making the valuation here, did you go into the assets held by the Newark Theatre Amusement

Corporation? A. I did make a calcu..ion for myself as to what the costs would be under these exchanges, but in the final analysis it comes down to the same thing, what this cost (Page 32) in Patterson and Newark were finally wound up in the Newark Theatre Building Corporation.

Q. But you didn't know what it cost the Newark Theatre Amusement Corporation, the first was 383 shares for what? A. Newark Theatre Amusement Corporation.

Q. You don't know the cost basis for that? A. Yes, sir.

Q. You had made no analysis of that? A. Yes, I have, because the Newark Theatre Amusement Theatre Corporation got their assets from the partnership too on the same date, January 1, 1928.

Q. Oh, I see, there were five corporations formed again from this partnership, is that correct? A. Yes, sir.

Q. And the 1,400 shares were exchanged for 2,800 shares of Newark Theatre Amusement Corporation, that is another one of the five corporations? A. That's right.

Q. Now, how many shares did Mr. Adam A. Adams hold at that time? A. 2,955 which included one qualifying share. On June 13, 1935, Mr. Adams exchanged 89 shares for 39 shares of U. S. Theatre Amusement Corporation and 50 shares of Adams Brothers Realty Company.

(Page 33) Q. Well now, the last two companies, what are the names of them? A. U. S. Theatre Amusement Corporation.

Q. And the other? A. Adams Brothers Realty Company.

Q. Were they formed from the partnership too? A. Yes.

Q. How many shares did he hold then at this stage? A. 3,044.

Q. All right now, what is the next transaction? A. July, 1936, 1,754 shares for 588 shares of Newark Theatre Amusement Corporation, that makes 4,798.

Q. What was the date of that? A. July 31st I think, 1936.

Q. And how many shares did he have at this time? A. I think that it is at this point, now just prior to that on June 13, 1935, he gave to his wife ten shares, which left him with 5,788 including Mr. D'Arcy's qualifying share.

Q. Now, what was the next acquisition? A. December 31, 1936, the stock dividend of 1,000 shares.

Q. Stock dividend declared by the Newark Theatre Building Corporation? A. Yes, sir.

(Page 34) Q. And does that make the total that we got set up here? A. 5,788 you have now. On October 19, 1938, there was a 2 per cent stock dividend of $115.96,* and at the same date the purchase of .04 share for the sum of $4 in cash, which brings us down to 5,904 shares. The one share was sold in 1939 I think or thereabouts or 1940 to Thomas Adams.

Q. In 1931, was there not issued $76,500 worth par value stock for theatre equipment? A. I think there was on March 31st.

Q. There was how much issued? A. $76,500.

Q. And was some of those shares of stock issued to the petitioner? A. No.

Q. None issued to the petitioner? A. No.

Q. Who were they issued to? A. The Newark Theatre Amusement Corporation.

Q. Now, how much depreciation was carried over from the partnership to the Newark Theatre Building Corporation on the books? A. None, it was taken at a net value.

Q. In other words, you did not carry over any de-
(Page 35). preciation of partnership over into the corporation, is that right? A. Not on January 1, 1928. Subsequently, however, through Government audit the adjustments were reflected after conferences I believe, they were

* Corrected: stock dividend of 115.96 shares.

reflected and the adjustments were made in 1932 when this stock was cancelled in order to take care of the difference.

Q. Do you know that as a fact? Do your books reflect that? A. An entry made to that extent?

Q. Yes. A. Yes, sir.

Q. Do you have there the reserve for depreciation account of the Newark Theatre Building Corporation? A. Yes, sir.

Q. For all years 1928 to 1941 inclusive? A. I think so.

Q. How many pages does it consist of? A. About six or seven pages.

Mr. Smith: Your Honor, I would like to offer in evidence the reserve for depreciation account of this corporation, in order to show that this $110,000 had never been properly reflected and in addition should be taken into consideration in arriving at the amount of basis in this case.

(Page 36) The Court: Could counsel perhaps stipulate what the books show with regard to the depreciation account?

Mr. Gutkin: If your Honor please, I don't think that what the depreciation account of Newark Theatre Building Corporation has or has not is material. However, I have no objection to trying to ascertain exactly the facts that Mr. Smith is trying to arrive at.

The Court We will take a recess at this time. Perhaps counsel can work out a stipulation.

(At this time a short recess was taken.)

Mr. Smith: If your Honor please, we have not been able to agree on those books, and I am going to withdraw my request or proposal to put that in as an exhibit. In lieu thereof, I shall put in some of these returns to bring out the point I shall make.

The Court: All right.

Q. Now, Mr. Sinner, I believe you testified that the earned surplus of Newark Theatre Building Corporation on January 1, 1944, was $44,269.40, is that correct? A. $45,629.05.

Q. All right now, the stock as a result of non-taxable dividends in prior years, what was that? A. $111,596.

Q. Now, what were the undistributed earnings of the calendar year 1941 of the Newark Theatre Building Cor-
(Page 37) poration? A. The undistributed earnings?

Q. Yes. A. Well, there is a profit for the year $16,520.42, out of which a dividend was declared $8,871, leaving undistributed $7,649.42 for that year.

Q. That should have been included as part of the accumulated earnings, shouldn't it? A. That would be the addition for that year.

Q. For that year? A. Yes, of course, there are in addition to that two surplus adjustments for additional income taxes for prior years.

Q. Now, I want to ask a question about the genesis for your basis of ascertaining the cost in this case. I believe you testified that the cost of the land and buildings of the partnership was $937,000? A. I think it is, I think that is what it said on the books here.

Q. Now, how much did Adam A. Adams pay into that, how much was the cost to him, to Adam A. Adams, the petitioner of that $937,000, what was his cost? A. It would be half of that.

Q. What is that? A. It would have been half of that.

(Page 38) Q. How do you know? A. That is what the books show.

Q. That is what the books show? A. Yes.

Q. Now, was that amount paid by Adam A. Adams in cash? A. No money.

Q. How was it paid? A. It was some cash and some mortgage.

Q. All right, give us the details of how it was, how much was cash and how much was mortgage? A. The detail of what you are asking me now, you mean the date of acquisition?

Q. Yes. A. I don't have it with me.

Q. You don't know what the cost was to Adam A. Adams when this property was acquired, do you? A. Yes, in 1924 when these books were opened we did find the cost and we did find what he still owed on it.

Q. But you don't know how that was paid, do you? A. Well, my memory does not serve me, I will probably have papers in my office to show how I arrived at it.

Q. You don't know whether it was paid by cash, to what extent or to what extent was paid by stock? (Page 39) A. Originally, I don't remember, no, sir.

Mr. Smith: No further questions.

Re-direct examination by Mr. Gutkin:

Q. Mr. Sinner, do the books that you have here assist you in arriving at the cost to Mr. Adams of the stock of the Newark Theatre Building Corporation in so far as his cash and other property contribution to the Newark Theatre Building Corporation? A. Yes, the books reflect all assessments.

Q. Are you able to state how much of cash and how much of other property, or are you only able to state the total as shown on the books? A. Well, the books would reflect the opening entry as of January 1, 1928, which consists of cash, other property and so forth, property stated at that time as an appreciated value, I stated that before. Subsequent to audit by the Government at conference they arrived at values and the adjustment was reflected on the

books of the Newark Theatre Building Corporation in 1932. The same thing was done in Patterson, the U. S. Theatre, in fact there was a case before the Tax Court which finally fixed the valuation of that building, I think that is in 1931, I am not sure but I think so.

Q. What does your opening entry show as to Mr. Adam (Page 40) A. Adams' cost for his stock in this corporation? A. The opening entry did not reflect absolute cost when it was adjusted.

Q. What was the entry? A. The opening entry showed cash $4,378.25, unexpired insurance $1,963.42, real estate and $500,000 real estate buildings and additions $570,000. Against that the credits are mortgage interest accrued $1,341.67, mortgage payable $575,000, common stock issued $500,000.

Q. What according to the books was the total contribution of stockholders to the corporation? A. According to that entry it was $500,000. It was subsequently amended in January, 1932.

Q. What was the result of that amendment or readjustment? A. $125,600 of treasury stock received in order to cancel out $125,665. of appreciation. The adjustment and surplus is $65.

Q. So that after you readjusted the accounts for an amount of appreciation as was set up on the books, what would books indicate as Mr. Adams' cost? A. Originally you are talking about in 1928?

Q. Yes. A. $134,612.54.

Q. And that the other parts of his costs were as (Page 41) testified by you earlier as to the amounts paid on the subsequent issuance of stock? A. Yes, sir, and his other costs are the investments in these other companies.

Q. And the total was how much? A. The total including the other eleven shares was $418,719.09.

Kurt M. Sinner, for Petitioner—Re-cross.

Q. And the cost of the 5,903 shares? A. $417,944.28, taking into consideration the four dollars.

Q. On December 6, 1940, how many shares of stock were issued and outstanding? A. 5,914.

Q. On January 27, 1941, immediately prior to the exchange how many shares were issued and outstanding? A. 5,914.

Q. On both of those dates how many shares did Mr. Adams own? A. 5,903.

Q. You stated an amount of fees paid to the office of Arthur T. Vanderbilt in the year 1941? A. I didn't say that. He asked with respect to this transaction.

Q. With respect to this transaction? A. Yes, sir.

Q. You also were asked whether the total savings in franchise taxes was $400. (Page 42) A. $400 and some odd dollars, I can tell you the amount exactly if you want it.

Q. Would that have been per year or all together? A. Per year.

Q. In other words, every year of the existence of the corporation that amount would be saved, is that correct? A. That's right. You want the exact amount?

Q. All right, will you state the exact amount? A. $413.98 per year.

Q. Each and every year of the corporation's existence? A. Yes, sir.

Q. In cross examining, it was stated that you had just computed the cost basis. How long a time did it take you to recompute Mr. Adams' cost basis? A. A couple of weeks.

Mr. Gutkin: No further questions.

Re-cross examination by Mr. Smith:

Q. Mr. Sinner, when you are talking about entries there in books, you are talking about entries in the books of the

Newark Theatre Building Corporation, aren't you? A. Yes.

Q. And the answers you have given to these various questions of counsel for the petitioner are referring to those books? (Page 43) A. Yes.

Q. And the costs set up in the books of the Newark Theatre Building Corporation? A. Yes.

Mr. Smith: No further questions.

Re-direct examination by Mr. Gutkin:

Q. So far as you know of your own knowledge do these books truthfully and accurately represent the actual amounts as set forth therein? A. I didn't follow that question.

Q. Are the books true and correct reproductions of actual transactions that occurred as at the time of the entry? A. Yes.

Q. And they were kept in the ordinary course of business of the Newark Theatre Building Corporation? A. Yes, sir.

Mr. Gutkin: No further questions.

The Court: That is all, sir.

Whereupon,

ADAM A. ADAMS,

called as a witness on behalf of the petitioner, after having been duly sworn testified as follows:

Direct examination (Page 44) *by Mr. Gutkin:*

Q. What is your full name? A. Adam A. Adams.

Q. Where do you reside? A. 251 Elmwind Drive, Orange, N. J.

Q. Mr. Adams, you are the petitioner in this court, are you not? A. Yes, sir.

Q. You are familiar with the events leading up to the recapitalization that Mr. Sinner testified to? A. Yes, sir.

Q. You heard Mr. Sinner's testimony? A. Yes, sir.

Q. What were the reasons that led to the recapitalization? A. Up to 1935 my brother and I, Mr. Peter Adams, [redacted] were on a bond, on a mortgage to the Prudential Insurance Company, another bond to the Fidelity Union Trust Company. We got a loan way back in 1924 of the Prudential Insurance Company for the Prudential Insurance Company to grant that loan that existed that both Mr. Peter Adams and I be guarantors to that bond which we did. In 1935, Mr. Peter Adams and I we divided properties as Mr. Sinner testified and he took possession of the Patterson properties and I took possession of the Newark properties.

(Page 45) Still Mr. Peter Adams, he was a guarantor to the Prudential Insurance Company and to the Fidelity Union Trust Company as a guarantor of his loans. Still, he was out of this corporation, the Newark Theatre Building Corporation and repeatedly he demanded that his signature must be eliminated from those bonds.

I repeatedly took the matter up with the Prudential Insurance Company and they refused to let Mr. Peter Adams' signature off the bond. Therefore, there was a search, I looked out to replace the Prudential mortgage and one company later gave me a loan without a personal guarantee. Now, in 1941, I figured that if I had some bonds perhaps I would have to put them as a collateral to get a loan in behalf of the Newark Theatre Building Corporation. That was the main object which we arrived at in this exchange from stocks to bonds.

Adam A. Adams, Petitioner—Direct.

Q. Now, this mortgage that was held by the Prudential Insurance Company, was that an open mortgage or did it still have a term to run? A. The Prudential Insurance Company had a mortgage from 1924 for five years and it ran to 1938 and the Prudential demanded money by paying them a fee, searching fee and some expenses, extended the mortgage for another three years, I presume up (Page 46) until 1941 or 1942.

Q. So that you knew that the mortgage would shortly become due and payable? A. Exactly.

Q. Now, what were the other reasons for the exchange? A. The other reasons was another mortgage held by the Fidelity Union Trust Company, the branch in Newark. In that, my brother was on the bond and he insisted that his signature must come out of that bond also.

Q. In other words, by his signature coming out of the bond, that he be relieved of liability by refinancing? A. Yes, sir.

Q. Now, was any purpose to save New Jersey franchise taxes?

Mr. Smith: Now, that is a pretty leading question.

Mr. Gutkin: I will withdraw that.

Q. Were there any other reasons? A. Well, as Mr Sinner stated I have two boys which they joined with me in business in 1941 and I want to give the boys some bonds.

Q. Did you believe that your operation of the business was of benefit to the corporation or did you think that a change of control would enure to the detriment of the corporation? (Page 47) A. I did that for the benefit of the corporation because even a second mortgage which I placed, the Newark Theatre derived the benefit because the present rate I am paying today is less than the Newark Theatre building was paying to the Prudential. The rate was 5%

to the Prudential and today I pay 4%. The present mortgage which I replaced the Prudential with is 4% instead of 5% which I paid to the Prudential. There is a benefit of 1% in interest on the mortgage.

Q. You have been engaged in the business of operating theatres in the State of New Jersey for how long a period of time? A. Since October 8, 1908.

Q. In what cities have you operated? A. First at 136 Market Street, Patterson, N. J.

Q. You needn't give the addresses, just the cities. A. Patterson, N. J.

Q. What other cities? A. Palisades Park, Palisade, N. J.; Newark, N. J. and Leonia, N. J.

Q. What has been the history of the movie theatre business in the City of Newark, N. J., in the downtown theatres where the 193-195 Market Street is located?

Mr. Smith: Since when?

Q. For the period of about 15 years prior to Jan. 27,
(Page 48) 1941, up to the end of 1941? A. I can't understand the question.

Q. What is the history, the trend of the theatre business in the downtown section of Newark for the years, 1926 to 1941, inclusive? A. Up to 1928 the theatres in downtown Newark, outside of two theatres that were controlled by independents—in 1928, the Warner Brothers acquired about 35 theatres in the vicinity of Newark and surrounding area and that became circuit control.

Q. Would you please try to talk a little louder, Mr. Adams? A. Now, in 1931, the Paramount Pictures, Inc., they were looking for an outlet for their pictures in the City of Newark and the City of Patterson. There were two or three theatres available to Paramount Pictures, Inc. They entered into an agreement with me as president of the Newark Theatre Building Corporation to make a 20 year deal

which we did under the specified conditions of the agreement.

Q. Was the theatre business prosperous or declining? A. The theatre business in 1931 was declining because the motion picture industry changed the production around 1929 from silent pictures to talking pictures, so like I said before there were two or three theatres available for Paramount, which they could rent in Newark. They entered into an (Page 49) agreement with me, because Paramount even today has an interest on 1,400 theatres and they are looking more for manpower than theatres.

Q. Now, Mr. Adams, coming back for a moment to the purposes of the recapitalization, you stated that one of the purposes was to have bonds available instead of stock so that it could be used by the corporation as collateral against any proposed loan the corporation might make to refinance. Now, in addition to that were there any other purposes?

Mr. Smith: Right there I object to counsel reciting what he said was the reason. I didn't hear it all myself and I don't know whether that is what he said.

Mr. Gutkin: The record will show what he said.

Q. What other purpose might there have been if you can recall any? A. As I said before, my boys——

Q. You said that, but in addition to that you were about to say something else? A. I can't recall.

Q. You started to say four hundred some odd dollars. What were you referring to? A. The State tax.

Mr. Gutkin: All right, your witness.

Cross examination by Mr. Smith:

(Page 50) Q. Mr. Adams, you have heard the accountant, Mr. Sinner, testify with reference to the books of your

partnership and of the Newark Theatre Building Corporation? A. That's right.

Q. And you also heard him testify as to the amount of the cost of your stock, did you not? A. Yes, I heard him mention it.

Q. Do you remember that? A. Yes.

Q. And you remember that we also had a discussion with reference to the amount of depreciation coming over from your partnership over to the corporation, do you remember that? A. Yes.

Mr. Smith: I would like to offer this protest as Respondent's Exhibit A for Identification.

The Court: Let it be marked.

(Protest received and marked Respondent's Exhibit A for Identification.)

Q. Mr. Adams, I show you a document which is marked "Protest" dated December 6, 1930, and ask you if that is your signature? A. Yes, that is my signature.

Q. And it is a protest to appeal as to certain depreciation factors? (Page 51) A. Yes.

Q. And that was prepared for you and signed by you, was it not? A. It was not prepared by me.

Q. I mean by your accountant? A. That's right.

Q. And signed by you? A. Yes, but I don't know who it was prepared by.

Q. And those are the statements that you signed and swore to in that document, that is your signature? A. Yes, sir.

Mr. Smith: I should like to offer this in evidence for the purpose of showing in this protest the taxpayer shows what reserve for depreciation was taken over from the corporation, reserve for depreciation that was in reserve by the partnership on December

31, 1927, on the buildings which are the subject of controversy in this case and which entered into the question of cost basis, which is an issue herein.

Mr. Gutkin: I object to the offer, your Honor, on the ground that it is not the best evidence of the facts that Mr. Smith is offering and that it is incompetent.

The Court: Objection overruled, admit it in evidence.

Mr. Gutkin: I take an exception.

(Page 52) The Court: Exception granted.

(Protest marked Respondent's Exhibit A for Identification received in evidence and marked Respondent's Exhibit A in evidence.)

Mr. Smith: No further questions.

Whereupon,

CHARLES F. KRAMER,

called as a witness on behalf of the petitioner, after having been duly sworn, testified as follows:

Direct examination by Mr. Gutkin:

Q. What is your full name? A. Charles F. Kramer.

Q. What is your address? A. 786 Broad Street, Newark, N. J.

Q. Mr. Kramer, would you kindly state your business or occupation? A. Real estate business and appraiser since 1900.

Q. How long have you been engaged in the appraisal of real properties? A. 40 years.

Q. And where is your appraisal business conducted? A. 786 Broad Street, corner of Market, Newark, N. J.

Charles F. Kramer, for Petitioner—Direct.

Q. In what vicinity generally do your appraisals take place, properties in what localities? A. Jersey, New Jersey, and particularly the Central (Page 53) part of New Jersey.

Q. Does that include the City of Newark? A. Oh, yes.

Q. Of what societies are you a member? A. All real estate organizations, a member of the New Jersey charter of the State Associations and National Association, the Master Appraisal Association, the American Appraisal Association, New York Industrial Brokers' Association, in fact all of them.

Q. Are you a member of the American Institute of Appraisers? A. Yes, sir, I am an M. A. I.

Q. Did you have any part in the founding of any of these appraisal societies? A. I am known as the dean of real estate men in this state.

Q. In other words, Mr. Kramer, I don't want you to feel as though you are saying some things that I have to draw from you, kindly help me to expedite your qualifications. Would you state some of the clients for whom you have made appraisals? A. Oh, yes, I can give you a few. In the last ten years I have served the United States Government, both Navy and Army; Interstate Commerce Commission; Chancery Court of the State of New Jersey; State Highway Commission of New (Page 54) Jersey; City of Newark, N. J.; City of Elizabeth, N. J.; City of Asbury Park, N. J.; City of Atlantic City, N. J.; Prudential Insurance Company of America; Fidelity Union Trust Company of Newark; Metropolitan Life Insurance Company; Guardian Life Insurance Company; Travellers' Life Insurance Company of Hartford, Conn.; Irving Trust Company; Penn. R. R.; Firemen's Insurance Company; United States Housing Authority; the Home Loan Bank.

Q. Have you ever served as an expert in condemnation proceedings? A. Oh, yes.

Q. And in what connection? A. I was employed by the City of Newark in the Newark Subway, acquisition of lands and rights of way; Pennsylvania R. R., Market St. Station and surrounding lands; the acquisition by condemnation of three United States Government housing units; acquisition of rights of way for Pennsylvania Railroad; Sears Roebuck Condemnation of Plants at Port Newark; Federal Shipbuilding Corporation's lands at Port Newark; Coastal Oil Company lands at Newark Bay. I was attached to the City of Newark Government for thirty years as real estate expert and tax consultant up until 1932 or 1933.

Q. Mr. Kramer, you recall that you were requested to investigate the properties owned by the Newark Theatre (Page 55) Building Corporation at 193-195 Market Street, in the City of Newark? A. Yes.

Q. Were you consulted in that connection? A. I was asked by Mr. Adams on September 20th, to make an appraisal of the Newark Theatre property and additional property at 286 Market Street.

Q. September of what year? A. This year, September 20th.

Q. 1944? A. 1944.

Q. Were you ever engaged in connection with an appraisal of the Market Street property at any time prior to September, 1944? A. Oh, yes, I appraised this property. I appraised it possibly half a dozen times for tax appeal purposes.

Q. Did you ever appraise it for any other purpose? A. No, I don't think so.

Q. Do you recall any appraisal that you made in 1940 with respect to this property? A. I may have, I have been making so many appraisals for various clients.

Q. In 1940, do you recall? A. I might have made one, I can't qualify as to whether I did or not. You are referring to this appraisal?

(Page 56) Q. I am referring to this appraisal. A. Oh, yes, I made this appraisal as of January 1, 1941 and got my notes out of examination of the property as of December 15th to December 30th of 1940.

Q. In other words, on December 15th to December 30th of 1940, you investigated this property and made an examination and made notes with respect to the property? A. Yes.

Q. And your valuation? A. Yes.

Q. Were you informed as to the reason for the request for appraisal? A. No, sir.

Q. Do you have any papers or documents that you can use to refresh your recollection with respect to the appraisal of the examination of the 193-195 Market Street, Newark? A. My appraisal as I made it and submitted it under my signature to Mr. Adams.

Q. Will you state what valuation you have arrived at for the property located at 193-195 Market Street and the basis for that valuation, stating all the factors that you used in arriving at the valuation?

Mr. Smith: Now, if Your Honor, please, he is putting the cart before the horse. He wants the valuation before he knows what he did to arrive at it and I object to the question.

(Page 57) The Court: Overruled, as of what date?

Mr. Gutkin: As of January 27, 1941.

The Witness: Yes, it will cover that period.

Q. Will you state the factors that led to your valuation, the method that you used to arrive at your valuation and finally the valuation? A. I appraised this property from

a reproduction and replacement standpoint, from an official survey and my personal inspection and knowledge of the property. The value of the land, consisting of a lobby, the portion fronting on Market Street, 39.67 by 100 feet, which I appraised at $3,000 a front foot, which makes $119,000. This property spread out in an "Ell" to a street known as Beaver Street, where its front 78.76 x 100 feet at $600 a front foot, a total of $47,256. The rear lands of Market and Beaver Streets comprise an area of 10,425 square feet, which I appraise at $5.20 a square foot or $54,306. There is an alleyway running in from Market Street on the westerly side of this property. We allow 5% for the alleyway or $3,128., giving a total land valuation of $223,700. I capitalized the building, which was built in 1890 and remodelled in 1927 or 1928 as follows: The theatre building is 60 feet high with eaves above the ground, 60 feet, and 20 feet with peak above eaves. It contains 1,078,222 cubic feet at 36¢ a cubic foot which is $388,160. Its main body is 51 years old but as (Page 58) same was remodelled in 1927, we only apply a 50% depreciation, $194,080., leaving a net value for the main building of $194,080.

On the Beaver Street "Ell", there is a four story and a two story brick building, a brick mercantile building, 45.5 x 46 x 51 feet high; two story 17.5 x 46 x 20 feet high, over 70 years old, in very poor condition, containing 107,523 cubic feet. There is a storage vault which contains 43,835 cubic feet. The boiler storage has 360 cubic feet and tunnels underneath 25,140 cubic feet, making a total of 176,958 cubic feet, which I value at 20¢ a cubic foot or $35,384. less 70% depreciation, which is $24,769., giving me a net value for this Beaver Street building of $204,695, added to my Market Street frontage gives me a total replacement and reconstruction value as of January 1, 1927, of $428,395.

Q. I think you misstated the date? A. January 1, 1927.

Q. I think you were referring to 1941? A. Yes, excuse me, January 27, 1941.

Q. What was the total value? A. $428,395.

Q. I show you a photograph which purports to be a photograph of the Theatre property in question and ask you whether this is a true photograph of the property? (Page 59) A. That is a true photograph I took myself from the frontage on Market Street, composed of about 40 odd feet and shows the lobby entrance to the main building.

Q. I show you another view of the same building? A. This is a lateral photograph taken showing the contiguousness of this building to Broad Street on the North side.

Q. I show you another photograph which purports to be the Beaver Street building? A. This is the four story and the two story building, the "Ell" running out from the main body to Beaver Street.

Mr. Gutkin: With consent of counsel for the respondent I offer in evidence the three photographs just identified by the witness.

The Court: Admitted in evidence.

(Photographs received in evidence and marked Petitioner's Exhibit No. 9 as of this date.)

Q. Now, Mr. Kramer, will you state what your investigation with respect to the ownership of this property revealed and the history of the operation of this building? A. My examination shows that there was a lease entered into——

Q. Pardon me, before that might I state that Page 5 of your report might be used to refresh your recollection in that connection. (Page 60) A. In my introductory I refer to the entire building being owned by the Newark Theatre Building Corporation and leased its entirety to the Essex Amusement Corporation by a long term lease.

Charles F. Kramer, for Petitioner—Direct.

This property has been assembled for over fifty years for the use of a theatre and the building was constructed in 1870 for a legitimate playhouse, containing an orchestra floor, balcony and gallery in addition to its large and well equipped stage, scenery and storage rooms and dressing rooms.

The house changed ownership several times in the early part of the century and finally was acquired by the present owners in 1921 who in the next years, thoroughly remodelled the building and removed the upper gallery.

This theatre was operated as a vaudeville house for a number of years and subsequently turned into an exclusive motion picture house. This latter event took place on or about March 13, 1931 when the owners leased the premises to the Essex Amusement Corporation for a period of 21 years, which lease expires on March 12, 1952, having twelve years to run from January 1, 1941.

Q. Now, will you describe the lease with respect to that property? A. Well, I have the lease here before me. It is a very lengthy one, but briefly it is a lease for a period (Page 61) of years that I have mentioned at $104,000 gross per year.

Q. Is the landlord required to pay the expenses of maintaining the building, taxes and other operating expenses, including salaries and so on? A. Yes.

Q. So that it is a gross rent, not a net rent? A. Yes.

Q. Have you investigated who the Essex Amusement Corporation might be? A. Well, I do know that Mr. Adams is part owner in it and I think if I understand rightly Paramount Theatre people may have an interest in it.

Q. I didn't mean exactly that, the Essex Amusement Corporation is a corporation of New Jersey, do you know? A. Yes.

Q. Now, will you state what has been happening with the locality of Broad and Market Street and Broad and

Mulberry Streets, in the City of Newark, in other words, what has been the trend? A. Market Street, from Broad Street east to Mulberry Street, consists of 100 per cent mercantile occupancy and for many years was the second best business and shopping center in Newark. The south side was considered the better trafficked side of this street.

Q. On which side is this? A. The theatre is located on the north side. The splendid service of the Public Service Corporation's trolley (Page 62) lines, which routed, the Irvington, Bloomfield, New York City, Orange and South Orange trolleys over this street to the Market Street Depot, were essentially responsible for much of the traffic and business done here. However, in 1926 many of these lines were rerouted and several important lines taken off the street, and with the removal of the Market Street Station of the Pennsylvania Railroad from the south of Market Street to the north side of said street, another decided change took place, for the traffic from Broad Street that formerly went to the Pennsylvania Railroad Station while on the south side of the street, now shifted to Commerce Street and Raymond Boulevard, causing a decided loss of traffic and its consequent effect upon the purchasing power and rentals and values. Many of the older firms removed from this section of Market Street and a great number of these buildings remained idle for many years, some as long as ten to fifteen years. Among these buildings are 223 Market Street, Ruckelshaus Building; 228 Market Street, Froehlich & Koehler Building; 224-226 Market Street, Spingarn Building; 185 Market Street, Niagara Building and 135 Market Street. In the years from 1925 to 1930, front foot values ranged from Five Thousand Dollars ($5,000) at Broad and Market Streets and gradually decreased toward Beaver Street and continued to do so to Mulberry Street, the range being from Four Thousand Dollars ($4,000) to Three Thousand Dollars

(Page 63) ($3,000) at Beaver Street and from Three Thousand Dollars ($3,000) to Two Thousand Dollars ($2,000) at Mulberry Street. In 1925 the stores and buildings were generally all occupied but already a beginning of lethargy became noticeable when the traffic fell off and the trolleys were rerouted. Merchants clamored for relief on their leases and readjustments of rental downward was a general occurrence.

In the next year, vacancies began to appear and the office buildings such as the Bonnell Building at 196 Market Street and the Niagara Building at 185 Market Street, had only the store floors rented at reduced rentals and lost their entire office tenants from the upper floors.

Front foot rental basis in 1920 to 1925, ran as high as Two Hundred Dollars ($200) to Three Hundred Dollars ($300) a front foot, only to drop to One Hundred Dollars ($100) to One Hundred and Fifty Dollars ($150) a front foot in 1930 and since this year to 1941, there no longer is any steadfast rental value but rather tenants were placed in various stores at rates ranging from Seventy-five Dollars ($75) to One Hundred Dollars ($100) a front foot with about 40% vacancies.

The trend was definitely and decidedly downward with little hope for any great betterment. The shrinkage was so rapid that the City Taxing Authorities could not keep pace with same and we find many of these properties offered for (Page 64) one-half of what they are assessed for taxation purposes.

The high prevailing tax rates, ranging from 5.30 to 5.50 was also a serious factor in this value shrinkage for none of these buildings could be rented at figures high enough to pay the overhead if taxation was not more moderate and commensurate with conditions.

Amid this chaotic condition there are only three properties that maintained their equilibrium during this depres-

sion period. They are the Newark Evening News at 215 Market Street, the Newark Theatre property at 193-195 Market Street and the Ordway Building at 207 Market Street, this latter being an office building.

Over 30% of the entire frontage on this block of Market Street, between Broad and Mulberry Streets, have been foreclosed against and are now in the hands of Banks and Insurance Companies.

These facts are stated to show the existing conditions during the years from 1925 to 1940 and for a better understanding for the arrived at values.

(Page 65) Q. Now, did you make an investigation as to the condition of motion picture houses in New Jersey in 1941, referring to Page 30 of your statement? A. Yes, sir, motion picture houses in the City of Newark I am sorry to say are in a very deplorable condition due to the fact that the success of a motion picture house depends upon the ability of procuring a first run picture and management that can maintain them and keep it up. Now, as a matter of fact it might be interesting, in 1940 I made an investigation of that question of motior picture houses in New Jersey so that in 1940 and 1941, of the 435 theatres in this state, 48 were closed. There are five first run picture houses in Newark. Each of these theatres has the policy of showing two pictures each week, which means that each theatre needs 104 first run pictures per year. In the period 1939, 1940 and 1941, the average first run pictures produced in America was under 400 a year. This means that the five theatres in Newark need a total of 520 pictures per year. Whereas, less than 400 were produced. Evidently the success of first run motion picture houses depend on the ability of the management to secure the pictures and net earnings are therefore closely tied up with the management and ability to secure the necessary productions. This is reflected in this appraisal property rentals, the feature of an extraordinary hazard

and the tenant finds him- (Page 66) self engaged in a highly speculative business.

Q. Now, Mr. Kramer, you made an appraisal based on the capital stock of the income and the expenses of the company and what is the amount of your appraisal based on that method? A. I made a capitalization appraisal on the basis of $104,000 gross rental and allowed for my yearly expenses as follows: Insurance $888.29; clerk, $227.75; average repairs, roofs and foundations as are specified in the lease, $1,000; water, $91.44; accountant and legal expenses $2,459.44; Miscellaneous, $768.96 all of which items were taken from the actuary books, making a total of $5,436., leaving me a net income of $98,564. As is customary, we apply to the land a value of 6% interest and $4.85 taxes for the year 1940 or 10.85 times the land value of $223,700 gives me $248,884., leaving me net value applicable to the building of $74,290., which I capitalized with a risk rate of 20% and taxes at $4.85 and depreciation rate of 5%, or a total of $29.85, capitalizing this amount $74,290. by $29.85, we have a value of $248,884., which added to my land value of $223,700. I have a total capitalized value of $472,584. and as I have stated before this is primarily based upon the fact that if we obtained the first run picture and the franchise for twenty years to maintain that first run picture and the able management that the building is under and has (Page 67) succeeded. If this building did not have the franchise and I had to appraise this property under personal conditions as I find it in the City of Newark, I would not appraise this property in the market value of over $250,000 and I state that advisably because last month or within the last 60 days two of our theatres outstanding, the Mosque, which cost three and a half million dollars, has a greater seating capacity than this house, located on Broad Street, was sold for around $200,000, and the Super Theatre which is also a house larger than this, costing close under $800,000 was sold for $225,000.

Q. I notice in your computation of expenses, you did not charge anything for management of the property? A. I left that out purposely because I thought possibly I would be unfair to the appraisal to charge up any management fee inasmuch as it was such an inter-related state of affairs.

Q. If any amount were to be charged for management— A. That would lessen my total value.

Q. Now, Mr. Kramer, do you know of any other leases on this north side of Market Street, properties located nearby? A. Mr. Counsel, I examined every lease and every piece of property from Broad Street down to Mulberry Street and as I told you 30% of them are pretty near all vacant, (Page 68) but the only outstanding lease that is in existence is the Grant Lunch Corporation, at 197-205 Market Street. That is on the same side and it has about 92 feet frontage by 100 feet deep and they paid $45,000 for it, and the only sale that has any semblance of bearing upon the situation is the sale of the Niagara building at 185 Market Street, which is three or four doors west of the property, at $66,000 and it has 22 feet and gives me a front foot value of about $3,000. Now, that is the only sale that exists.

Q. Now, did you make an appraisal of the property owned by the Newark Theatre Building Corporation at 286-288 Market Street? A. Yes, I did. I made an appraisal of the property at 286 and 288 Market Street, value of the land $29,022; building, $13,700; a total of $42,722. This property is located on the south side of Market Street, Newark, N. J., between Ward and Lawrence Streets, designated on the City Taxing Authorities maps as Block 161, Lots 10 and 11, and known as 286-288 Market Street, Newark, N. J.

Q. I show you a picture which purports to be a picture of the property at 286-288 Market Street, Newark, and ask whether that is the property? A. Yes, that is the property. I took that picture myself.

Charles F. Kramer, for Petitioner—Direct.

Mr. Gutkin: I offer it in evidence.
(Page 69) Mr. Smith: No objection.
The Court: Let it be marked.

(Picture received in evidence and marked Petitioner's Exhibit 10 in evidence.)

Q. Mr. Kramer, before we continue with that, may I ask you, am I correct in assuming that the property that you are talking about is the one which has a sign on it, "Friedman's Clothing", "Jay's Men's Shop", and "We Buy And Sell Diamonds"? A. That's right, three little stores, it is a taxpayer as it were.

Q. Now, will you kindly continue? A. This plot is rectangular in shape, having a frontage on Market Street of 51.08 feet, with a depth of 100 feet, running through and facing Kirks Place, with a frontage of 45.66 feet. Market Street runs east and west, is 75 feet wide and is paved with asphalt cement pavement, and contains all the municipal improvements such as sewer, water, gas and electricity. It is the principal business artery running from the easterly section of the city to the courthouse, at the junction of Market Street and Springfield Avenue. This street is utilized by the buses and trolley cars of the Public Service Corporation, with lines to Irvington, Oranges, West Newark and the New York-Newark Lines. The most recent sales, in 1940, indicates a land (Page 70) value of $600 a front foot for 100 feet depth. There being an assessive 48.37 feet frontage at $600 a front foot gives a land valuation of $29,022.

Q. A land valuation? A. Yes, sir.

Q. Now, what is the valuation of the building? A. The building is a one story brick taxpayer, covering the entire plot and divided into three stores. This building contains 82,800 cubic feet at 30¢ a cubic foot which is $24,840. Depreciation over 25 years, is $12,420., giving me a net value

for building of $12,420., added to my land value gives me a total value of $41,442.

Q. Now, will you state your appraisal on the basis of the capitalization method of the rental? A. On this building?

Q. Yes.

Mr. Smith: What building are you talking about now, which one?

Mr. Gutkin: 286-288 Market Street, Newark.

A. The yearly rental income as estimated is $4,000 and there existed between 1935 and 1940, 50% vacancies.

Q. Was that the condition and has it been the condition for vacancies? A. From 1935 to 1940 there was 50% vacancies there.

Q. I didn't hear you, I'm sorry? (Page 71) A. The yearly expense is insurance $246, applicable to land 6% on $29,000. is $1,740, or a total of $1,986., leaving applicable to the building $2,034., which capitalized was 6% risk rate, $4.85 tax rate and 4% depreciation, or a total of $14.85, giving me a value of $13,700. upon building and $29,000. for the land or $42,700.

Mr. Gutkin: No further questions.

Cross-examination by Mr. Smith:

Q. Your name is Mr. Kramer? A. Yes.

Q. And I believe you stated you have been an appraiser for a good many years for the City of Newark? A. Yes, 30 years.

Q. Are you now an appraiser for the City of Newark? A: Yes, sir, that is not officially connected with the city. I am doing their work for them.

Q. They are hiring you to make most of their appraisals? A. That is all expert cases. I have five cases for the City of Newark today.

Charles F. Kramer, for Petitioner—Cross

Q. Now, in making appraisals for the City, for the purposes of taxes I suppose, isn't it, or assessing taxes? A. A good deal of my work is for other purposes. I am the father of Port Newark and developed Port Newark and I have a lot of waterfront experience and I have to do a lot (Page 72) of condemnation but I did a lot of consulting with the Tax Board.

Q. Now, in making valuations of that type, do you not make them very low in comparison to their actual value? A. For the City?

Q. Yes. A. No, the law calls for making true valuations in Jersey and we are supposed to do so.

Q. You are supposed to, but you do not? A. I say generally that some of the valuations are much lower than the true value.

Q. The petitioner had made a protest in 1940 over the valuation that was placed on this particular property we have in controversy. He protested to the Appeals Board?

Mr. Gutkin: I object to the question on the ground that this witness may not know what the petitioner has done and if he knows it, all right.

The Court: If he knows. Do you know whether or not he had appealed?

The Witness: I don't know whether he had made one in 1940 or not.

The Court: You don't know?

The Witness: No.

The Court: And when you made this appraisal you read there from a long document.

(Page 73) The Witness: That is my appraisal.

By Mr. Smith:

Q. Did you not make that in connection with the City appraisal also, isn't that a part of that? A. Oh, no.

Charles F. Kramer, for Petitioner—Cross.

Q. It doesn't have anything to do with that? A. No.

Q. Now, when Mr. Adams approached you about this matter what did he say to you? A. He said very little. The day he called me up he said, "I want an appraisal made of the property, the true value of my property at the theatre and down below and I want it ready and in the hands of Mr. Gutkin within the next five days."

Q. And he didn't tell you the purpose? A. No, sir, he never mentioned a word about it. I didn't even know it was a court case until a couple of days ago Mr. Gutkin told me.

Q. You didn't know it would have anything to do with the income tax case? A. Positively not, sir.

Q. Now, the main property here is 193-195 Market Street? A. Yes, sir.

Q. In the City of Newark? (Page 74) A. Yes, sir.

Q. Market Street is considered one of the main streets, isn't it, of Newark? A. One of the most important arteries running through the entire city, east and west.

Q. And on that are many business properties? A. Generally business.

Q. And several theatres? A. Yes, two theatres.

Q. And this property is one of the largest, is it not, of the theatres? A. Yes, sir, it is one of the largest centrally located theatre properties.

Q. And what is the seating capacity? A. 1,900.

Q. And it has been recently re-decorated, hasn't it? A. I don't keep track of that, but they are always doing a little something in theatres.

Q. Well, you made a very careful investigation of this property, didn't you? A. Yes.

Q. What is in the lobby, did you examine the lobby? A. It is decorated nicely, yes, sir, they change them every once in a while. They change the entire decorations.

(Page 75) Q. And those decorations are new there, aren't they? A. I should say they are very, very neat and very nice.

Mr. Gutkin: As of what date are we talking about?

Mr. Smith: Of the investigation he made in 1941.

Q. And you did this by the foot frontage, is that the way you estimated, your value? A. The Market Street frontage, I applied that by foot frontage and the Beaver Street also foot frontage.

Q. Beaver Street is where, in the back of the theatre? A. On the side in front Walker Street, a lateral street and this is an ell that runs out from the theatre into Beaver Street.

Q. Now, in making this examination what factors did you take into consideration? A. In regard to what?

Q. In regard to value of this property, what factors did you use? A. Factors as to what?

Q. As to making valuation, what did you consider? A. The front foot valuation as I knew it upon my experience from adjoining sales and leases.

Q. That is the way you did it? A. Yes.

Q. You did not take into consideration the earnings here, did you? (Page 76) A. Earnings?

Q. Yes, sir. A. I gave you a capitalized value statement here, I read that off.

Q. Now, when you made that capitalization, you said that that capitalization was 20%, did you not? A. Yes, sir.

Q. Why did you say 20%? A. Because of the enormous and excessive hazard and risk that this theatre is under and the condition of the motion picture industry not being able to pay the rents unless they have a first-run picture franchise.

Q. Well, the petitioner, the stock which we have in mind is the Newark Theatre Building Corporation stock? A. Yes.

Q. And they are the owners of the building? A. Yes.

Q. Now, they have a lease with the Essex Amusement Corporation? A. Yes.

Q. And the Essex Amusement Corporation is a subsidiary of the Paramount Theatre? A. That I don't know, I only understand that they share an interest in the Essex Amusement Company.

Q. Aud they do get the first run Paramount pictures, (Page 77) do they not? A. They have an agreement with the Paramount people I understand.

Q. Well, there isn't any risk there; can't the Paramount Pictures see to it that the pictures get there? A. I quoted that in my testimony that the assignment of pictures at the present time is very scarce and getting worse by the minute and in 1940 there were only 400 pictures produced and over 512 necessary to serve the theatres. In fact, this very theatre has to run the same picture for three or four weeks in order to bridge that situation.

Q. And do they not have capacity crowds for every picture? A. Do they have what?

Q. Capacity crowds? A. That I can't say, but they have good attendance, but I don't think the capacity is a very large word in this.

Q. Well, isn't the theatre filled up about four times a day?

Mr. Gutkin: Are we talking about 1941?

Mr. Smith: I am talking about 193-195.

The Witness: In 1940 it was not filled up to capacity as you speak of.

Q. Now, the different properties, that you don't know much about that though, do you? (Page 78) A. About what?

Charles F. Kramer, for Petitioner—Cross.

Q. How many people are going to the theatres? A. In this theatre?

Q. Yes. A. My office is right next door and I guess I pass that theatre about twenty times a day and I am in the theatre and out of the theatre very frequently and I think I know as much about it as anybody who has anything to do with the theatre.

Q. So that the theatre being located in downtown Newark and having a first run picture, is customarily filled up; isn't it, hasn't that been your observation? A. Better than the other houses. The other houses do not have anybody.

Q. Now, there is a lease in connection with this theatre that you speak about? A. Yes.

Q. I show you a document which is marked "Newark Theatre, Newark, N. J. lease" and ask you if that is the document you are talking about? A. Is this 1931?

Q. Yes. A. That's right.

Q. And this lease is dated March 13, 1931? A. Yes.

(Page 79) Q. And is to run for how long? A. 21 years.

Q. So that you still have from 1941, you still have ten years? A. Yes.

Q. And this lease calls for rent of $104,000 a year? A. Yes.

Q. Now, did you say that the expenses with reference to the running, that is the interest and so forth are to be taken care of by the landlord, the repairs? A. Yes.

Q. Well, how about new seats and all that inside stuff? A. That is covered by the agreement and the lease, the company pays that.

Q. You mean the lessee? A. Yes.

Mr. Smith: I would like to offer the lease in evidence in order that we will have it before us.

Charles F. Kramer, for Petitioner—Re-direct.

Mr. Gutkin: Will you please offer a copy, Mr. Smith?

The Court: You offer in evidence a copy of the lease, subject to comparison, Mr. Smith?

Mr. Smith: That's right, with the original.

Mr. Gutkin: No objection.

The Court: Let it be admitted.

(Page 80) (Copy of lease received in evidence and marked Respondent's Exhibit B in evidence.)

Q. If this lease has ten years to run, how can you justify a capitalization at 20%? A. Conditions, not the lease. The conditions surrouunding the moving picture industry and the hazard that it is laboring under has everything to do with the success of this lease and the success of this house.

Q. Even though the Paramount Theatre people themselves have their own pictures in there, is that right? A. Yes, that's got nothing to do with it. The Paramount Pictures may cease tomorrow morning if they are going the way they are now making fewer pictures everyday. It is hard to guess where they are going to wind up.

Mr. Smith: No further questions.

Re-direct examination by Mr. Gutkin:

Q. Mr. Kramer, are you familiar with the status of the corporation that was the tenant's lessee in 1935? A. Yes.

Q. What was that, the lessee?

The Court: The Essex Amusement Company.

Mr. Gutkin: I withdraw that, your Honor, no further questions.

The Court: That is all, Mr. Kramer.

Adam A. Adams, Petitioner, Recalled—Direct.

(Page 81)

ADAM A. ADAMS,

recalled as a witness on behalf of the petitioner, having already been duly sworn, resumed the stand and testified further as follows:

Direct examination by Mr. Gutkin (continued):

Q. Mr. Adams, you have heard the testimony with respect to this lease between the Newark Theatre Building Corporation and the Essex Amusement Company? A. Yes.

Q. What was the status of the lessee for years leading up to the year 1940 and 1941? A. When we entered the lease with the Paramount, Paramount wanted 50% of the Essex Amusement Company and at that time my brother wants 25% and I want 25%, that makes 100%. Now, in 1932, the Paramount, Incorporatives with all their affiliates went into bankruptcy and their receiver ran the Paramount Pictures and Paramount Pictures for a number of years to about 1935 or 1937 was run like that. During that time the Essex Amusement Corporation was unable to pay the rent to the Newark Theatre Building Corporation and if it was not for my own personal funds to put in, the Essex Amusement Corporation, for their rent, the Essex Amusement Corporation would have gone into bankruptcy like the rest of the Paramount Theatres. (Page 82) If it was not for me, my personal funds which kept the Essex Amusement Corporation out of bankruptcy, it would have gone into bankruptcy. That particular lease we entered in 1931 and the Commissioner will find from the lease, if the Paramount did secure my personal services, I had a contract of an additional five years with the Paramount people that I will manage the theatres and on that condition they entered the lease with the Newark Theatre Building Corporation for the Essex Amusement Company.

Adam A. Adams, Petitioner, Recalled—Cross.

The Court: You featured other movies more than those produced by Paramount?

The Witness: Maybe 2%.

The Court: How many first run movies does Paramount put out a year?

The Witness: Up to 1928 before the talking pictures they used to produce between 600 and 700 pictures a year since prior to 1928. After the talking pictures, the cost of each picture was three times as great than it would cost to produce a silent picture, therefore, all the producers curtailed production. Instead of having 700 pictures they got down to 300 or 350 pictures. They continued like that up to 1941 or 1942. Now, since our country entered the war because of the restrictions for celluloid which is required to produce the pictures, the pictures have been curtailed 50%. In other words, (Page 83) my records show today that back in 1935, 1936, 1937, 1938, I showed usually two pictures a week. Today, I run for instance one picture "Going My Way" for seven weeks, not because that picture should run seven weeks, but I had no other picture to follow it. In other words, I say Paramount today out of sixty pictures which they today have produced, no more than fifteen decent pictures are among them.

Q. Have you any security for your lease? A. No, sir.

Mr. Gutkin: You may cross examine.

Cross examination by Mr. Smith (continued):

Q. Mr. Adams, the Essex Amusement Company in 1941 was doing very well then, wasn't it? A. 1939, 1940, Essex acquired another theatre in Newark.

Adam A. Adams, Petitioner, Recalled—Cross.

And the other theatre did not go so good, that is the old Super Theatre which Mr. Kramer mentioned. That particular theatre was a failure for fifteen years. It was operated by different operators who tried to run the theatre successfully and they failed. In 1939, I acquired the building myself from the Prudential Insurance Company. The Essex Amusement Corporation took a lease on that building. We operated it in 1940 and 1941. (Page 84) Now, that particular theatre which I stated before was a failure for fifteen years, under my management is one of the outstanding theatres of the City of Newark.

Q. Now, Mr. Adams, I will show you what is called a gift tax return, a United States gift tax return for the year 1941 and ask you if that is your signature there on it? A. Yes.

Q. And you gave some of these deductions* which you acquired to your children that year in which you reported here? A. That's right.

Q. And you gave a value as stated in the return of $24,000——

Mr. Gutkin: Objected to, your Honor. I don't know whether Mr. Smith is making the witness his own for the purposes of this examination.

Mr. Smith: I don't know what he put the witness back on for. He seemed to put him back on too, which is irregular. What I want to do is to put in the gift tax return of the petitioner to show what value he put on these debentures when he gave them away in 1941, the exact date of the transaction here.

Mr. Gutkin: I think that might only be used to impeach the testimony of the witness.

(Page 85) The Court: Objection overruled.

Mr. Gutkin: I pray an exception.

* Corrected: debentures

Adam A. Adams, Petitioner, Recalled—Cross.

The Court: Exception noted.

(Gift Tax return received in evidence and marked Exhibit C in evidence.)

Q. Mr. Adams, this appraisal that was made in 1941 by Mr. Kramer at your request, did you or did you not tell him the purpose of which you were making the appraisal? A. I did not, I was trying to negotiate a loan for different insurance companies. I did not tell Mr. Kramer what I want the appraisal for and the reason which I asked Mr. Kramer to appraise my property was because I was looking for a loan and I wanted to satisfy myself how much my property was worth. That is the reason I asked Mr. Kramer to make an appraisal.

Q. Did you not make an appeal on this property from the assessment in 1940, did you or did you not? A. I don't know.

Mr. Smith: No further questions.

Mr. Gutkin: The petitioner rests.

Mr. Smith: It has been agreed that we put in these returns. I offer in evidence, I believe it will be better as separate exhibits, the corporation income tax returns of the Newark Theatre Building Corporation for the years 1928 to 1943 inclusive. We claim the debentures (Page 86) are worth their face value, which is $295,000 alone, not counting what the value of the stock might be in addition.

The Court: Any objection?

Mr. Gutkin: No objection to the introduction in evidence, but in characterizing its use for any purpose. I merely have no objection to the admission in evidence of these returns.

The Court: Admitted in evidence.

Colloquy.

(Returns received in evidence and marked Respondent's Exhibits E to [illegible] inclusive in evidence, for the years 1929 to 1943.)

The Court: Under the rules you know, gentlemen, the briefs in chief are to be filed simultaneously within 45 days and the reply briefs within 15 days. I don't see any reason why they should not be filed as provided for.

Mr. Gutkin: May I ask Your Honor's indulgence in asking the petitioner to submit within 60 days? I have so much work pending before the Tax Court in other cases and appeal matters, that it will be extremely difficult to write an adequate brief in 45 days.

The Court: Is there any objection?

Mr. Smith: No objection.

The Court: All right, 60 days and 15 days.

(Whereupon, at 5:15 P. M., the hearing terminated.)

Exhibit P-2.

MINUTES OF MEETING OF BOARD OF DIRECTORS.

A special meeting of the Board of Directors of Newark Theatre Building Corporation was held on Friday, December 6, 1940, at 3 P. M., at the principal office of the company in Newark, N. J., pursuant to a written waiver of notice signed by all of the Directors fixing said time and place.

The entire Board of Directors was present.

The Secretary presented and read the waiver of notice of meeting signed by all of the Directors, and the same was ordered filed.

The President stated that the meeting had been called to consider the desirability of revamping the capital structure of the company. He pointed out that in his opinion the whole capital structure of the company was not well balanced and that it was not sound business to have so top-heavy a capital set-up. He stated that in his judgment a simple plan of recapitalization could be evolved which would bring about the desired change with comparatively little expense to the company and which would eventually prove beneficial not only to the company but to its stockholders. He further advised that he had discussed the same with the accountant for the company, as well as counsel, and that they could see no accounting or legal difficulty in consummating a plan of recapitalization.

He suggested that the following plan be considered:

(1) A reduction in the aggregate par value of the authorized capital stock of this company from $600,000, represented by 6,000 shares of the par value of $100.00 each, of which 5,914 shares, or $591,400, are issued and outstanding, to $295,700, to be divided into 5,914 shares of stock without nominal or par value.

Exhibit P-2.

(2) The issuance by the company of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable semi-annually, on June 1st and December 1st in each year, and the principal whereof shall be payable in twenty years from the date thereof.

(3) The issuance by the company to the holders of the present capital stock, of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable semi-annually, on June 1st and December 1st in each year, and the principal whereof shall be payable in twenty years from the date thereof, plus 5,914 shares of the new common stock of the company without nominal or par value, in exchange for the shares of the present capital stock of the par value of $100.00 per share now held by them on the basis of one $50.00 bond and one share of stock without nominal or par value for each share of the present capital stock surrendered.

After a full discussion, upon motion, duly made and seconded, and by the affirmative vote of all present, it was

RESOLVED that the Board of Directors of this company deem it desirable and for the best interests of the company and its stockholders, and hereby declare it to be advisable that the present capital structure of this company be changed to provide for the following:

(1) A reduction in the aggregate par value of the authorized capital stock of this company from $600,000, represented by 6,000 shares of the par value of $100.00 each, of which 5,914 shares, or $591,400, are issued and outstanding, to $295,700, to be divided into 5,914 shares of stock without nominal or par value.

Exhibit P-2.

(2) The issuance by the company of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable semi-annually, on June 1st and December 1st in each year, and the principal whereof shall be payable in twenty years from the date thereof.

(3) The issuance by the company to the holders of the present capital stock, of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable semi-annually, on June 1st and December 1st in each year, and the principal whereof shall be payable in twenty years from the date thereof, plus 5,914 shares of the new common stock of the company without nominal or par value, in exchange for the shares of the present capital stock of the par value of $100.00 per share now held by them on the basis of one $50.00 bond and one share of stock without nominal or par value for each share of the present capital stock surrendered.

And Whereas, in order to carry out the aforesaid plan of recapitalization, it is necessary and advisable to amend the certificate of incorporation of this company, it is

Resolved that the Board of Directors of Newark Theatre Building Corporation, a corporation of the State of New Jersey, on this 6th day of December, A. D., 1940, do hereby resolve and declare that it is advisable to amend Article Fourth of the certificate of incorporation of the company to read as follows:

> "Fourth: The total authorized capital stock of this corporation is 5,914 shares without nominal or par value. All or any part of said shares may be issued by the corporation from time to time and for such consideration as may be determined upon and fixed by the Board of Directors as provided by law."

Exhibit P-2.

and do hereby call a meeting of the stockholders to be held at the company's office in the City of Newark, County of Essex, N. J., on the 6th day of December, 1940, at 4 P. M., to take action upon the above resolution.

FURTHER RESOLVED that the officers of this corporation be and they hereby are authorized and directed to do all acts and things that may be necessary and proper to carry into effect the foregoing plan of recapitalization, in compliance with the laws of the State of New Jersey.

There being no further business to come before the meeting, the meeting adjourned.

MARTIN W. D ARCY,
Secretary.

WAIVER OF NOTICE OF MEETING OF STOCKHOLDERS.

We, the undersigned, being all of the stockholders of Newark Theatre Building Corporation, a corporation organized under the laws of the State of New Jersey, hereby waive notice of the time, place and purpose of a meeting of the stockholders of the corporation, and fix the 6th day of December, 1940, at 4 P. M., as the time, and the principal office of the company, 193-5 Market Street, Newark, N. J., as the place of said meeting.

And we hereby waive all the requirements of the statutes of New Jersey as to notice of said meeting and the publication thereof; and consent to the transaction of such business as may come before said meeting.

Dated: December 6, 1940.

A. A. Adams (L. S.)
Marie A. Adams (L. S.)
Martin W. D Arcy (L. S.)

Exhibit P-2.

MINUTES OF SPECIAL MEETING OF STOCKHOLDERS.

A special meeting of the stockholders of Newark Theatre Building Corporation was held on Friday, December 6, 1940, at 4 P. M., at the principal office of the company in Newark, N. J., pursuant to a written waiver of notice signed by all of the stockholders fixing said time and place.

All the stockholders were present.

The Secretary presented and read the waiver of notice of meeting signed by all of the stockholders, and the same was ordered filed.

The President stated that the meeting had been called to discuss and take action upon a plan of recapitalization of the company which had been considered and unanimously adopted by the Board of Directors. He directed the Secretary to read the resolutions passed by the Board of Directors and that they be entered in the minutes of this meeting. The Secretary read as follows:

"RESOLVED that the Board of Directors of this company deem it desirable and for the best interests of the company and its stockholders, and hereby declare it to be advisable that the present capital structure of this company be changed to provide for the following:

(1) A reduction in the aggregate par value of the authorized capital stock of this company from $600,000, represented by 6,000 shares of the par value of $100.00 each, of which 5,914 shares, or $591,400, are issued and outstanding, to $295,700, to be divided into 5,914 shares of stock without nominal or par value.

(2) The issuance by the company of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable semi-annually, on June 1st and December 1st

in each year, and the principal whereof shall be payable in twenty years from the date thereof.

(3) The issuance by the company to the holders of the present capital stock, of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable semi-annually, on June 1st and December 1st in each year, and the principal whereof shall be payable in twenty years from the date thereof, plus 5,914 shares of the new common stock of the company without nominal or par value, in exchange for the shares of the present capital stock of the par value of $100.00 per share now held by them on the basis of one $50.00 bond and one share of stock without nominal or par value for each share of the present capital stock surrendered.

And Whereas, in order to carry out the aforesaid plan of recapitalization, it is necessary and advisable to amend the certificate of incorporation of this company, it is

Resolved that the Board of Directors of Newark Theatre Building Corporation, a corporation of the State of New Jersey, on this 6th day of December, A. D., 1940, do hereby resolve and declare that it is advisable to amend Article Fourth of the certificate of incorporation of the company to read as follows:

> 'Fourth: The total authorized capital stock of this corporation is 5,914 shares without nominal or par value. All or any part of said shares may be issued by the corporation from time to time and for such consideration as may be determined upon and fixed by the Board of Directors as provided by law.'

and do hereby call a meeting of the stockholders to be held at the company's office in the City of Newark, County of

Exhibit P-2.

ssex, N. J., on the 6th day of December, 1940, at 4 P. M., to take action upon the above resolution.

FURTHER RESOLVED that the officers of this corporation be and they hereby are authorized and directed to do all acts and things that may be necessary and proper to carry into effect the foregoing plan of recapitalization, in compliance with the laws of the State of New Jersey."

After a full discussion, upon motion, duly made and seconded, and by an affirmative vote of all present, it was

RESOLVED that the stockholders of this company do hereby ratify and approve the resolutions passed by the Board of Directors of this company providing for a revision of the capital structure of the corporation in the manner and terms set forth in said resolutions.

FURTHER RESOLVED that the proper officers of this company be and they hereby are authorized to execute and deliver any and all documents, papers, stock certificates, and bonds, that may be necessary to carry out said plan of recapitalization and as may be required by law.

There being no further business to come before the meeting, the meeting adjourned.

MARTIN W. D'ARCY,
Secretary.

Exhibit P-4.

Number 3

Shares 5903

Incorporated Under the Laws of the State of New Jersey

NEWARK THEATRE BUILDING CORPORATION

The corporation is authorized to issue 5,914 shares of stock without par value

FULL PAID AND NON-ASSESSABLE

THIS CERTIFIES THAT ADAM A. ADAMS is the owner of Five Thousand Nine Hundred Three Shares Without Par Value of

NEWARK THEATRE BUILDING CORPORATION

transferable on the books of the Corporation by the holder hereof in person or by duly authorized Attorney, upon surrender of this Certificate properly endorsed.

WITNESS the Seal of the Corporation and the (Seal) signatures of its duly authorized Officers affixed this twenty-seventh day of January 1941.

THOMAS A. ADAMS
Secretary
Treasurer

A. A. ADAMS
President

Exhibit P-5.

UNITED STATES OF AMERICA
STATE OF NEW JERSEY

No. 10 $12,000.00

NEWARK THEATRE BUILDING CORPORATION

6 Per Cent. Twenty Year Debenture
Due December 1st, 1960

NEWARK THEATRE BUILDING CORPORATION (hereinafter called the "Corporation"), for value received, hereby promises to pay to

ADAM A. ADAMS

or order, on the 1st day of December, 1960,

Twelve Thousand and no/100 Dollars

in legal currency of the United States of America, and to pay interest thereon from date of issuance, at the rate of Six (6) per cent. per annum, such interest to be payable in like legal currency, on the first days of June and of December in each year. Both the principal and interest of this debenture shall be payable at the office of the Corporation, 195 Market Street, Newark, N. J.

In the payment of their several claims in the event of liquidation or insolvency of the Corporation, the holder of this debenture shall rank pari passu with all other unsecured creditors of the Corporation, and superior to the stockholders of the Corporation with respect to their shares of stock.

This debenture is part of a duly authorized issue of $295,700.00 par value of 6% Twenty Year Debentures of the Corporation. All of said debentures are issued under and pursuant to resolutions of the Board of Directors

of the Corporation, enacted on December 6, 1940, and approved by the vote of at least two-thirds of the stockholders of the Corporation.

This debenture is transferable only on the books of the Corporation in person or by duly authorized attorney, upon surrender of this debenture properly endorsed.

In Witness Whereof, Newark Theatre Building Corporation has caused this instrument to be signed by its President, and its corporate seal, attested by its (Seal) Secretary, to be hereunto affixed, all as of this 27th day of January A. D., 1941.

Newark Theatre Building Corporation

By A. A. Adams
President

Attest:

Thomas A. Adams
Secretary

Exhibit P-6.

CERTIFICATE OF DECREASE OF CAPITAL STOCK AND AMENDMENT OF CERTIFICATE OF INCORPORATION OF NEWARK THEATRE BUILDING CORPORATION

The location of the principal office in this state is at 193-195 Market Street, in the City of Newark, County of Essex.

The name of the agent therein and in charge thereof, upon whom process against this corporation may be served, is Adam A. Adams.

RESOLUTIONS OF DIRECTORS

RESOLVED that the Board of Directors of this company deem it desirable and for the best interests of the company and its stockholders, and hereby declare it to be advisable that the present capital structure of this company be changed to provide for the following:

(1) A reduction in the aggregate par value of the authorized capital stock of this company from $600,000, represented by 6,000 shares of the par value of $100.00 each, of which 5,914 shares, or $591,400, are issued and outstanding, to $295,700, to be divided into 5,914 shares of stock without nominal or par value.

(2) The issuance by the company of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable semi-annually, and the principal whereof shall be payable in twenty years from the date thereof.

(3) The issuance by the company to the holders of the present capital stock, of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable

semi-annually, on June 1st and December 1st in each year, and the principal whereof shall be payable in twenty years from the date thereof, plus 5,914 shares of the new common stock of the company without nominal or par value, in exchange for the shares of the present capital stock of the par value of $100.00 per share now held by them on the basis of one $50.00 bond and one share of stock without nominal or par value for each share of the present capital stock surrendered.

And Whereas, in order to carry out the aforesaid plan of recapitalization, it is necessary and advisable to amend the certificate of incorporation of this company, it is

Resolved that the Board of Directors of Newark Theatre Building Corporation, a corporation of the State of New Jersey, on this 6th day of December, A. D., 1940, do hereby resolve and declare that it is advisable to amend Article Fourth of the certificate of incorporation of the company, to read as follows:

> "Fourth: The total authorized capital stock of this corporation is 5,914 shares without nominal or par value. All or any part of said shares may be issued by the corporation from time to time and for such consideration as may be determined upon and fixed by the Board of Directors as provided by law."

and do hereby call a meeting of the stockholders to be held at the company's office in the City of Newark, County of Essex, N. J., on the 6th day of December, 1940, at 4 P. M., to take action upon the above resolution.

Further Resolved that the officers of this corporation be and they hereby are authorized and directed to do all acts and things that may be necessary and proper to carry into effect the foregoing plan of recapitalization, in compliance with the laws of the State of New Jersey.

Exhibit P-6.

In Witness Whereof, the said corporation has caused this certificate to be signed by its President and Secretary and its corporate seal to be hereto affixed, this 6th day of December, 1940.

Newark Theatre Building Corporation

By A. A. Adams,
President.

Martin W. D'Arcy,
Secretary.

Certificate of Change

Newark Theatre Building Corporation, a corporation of the State of New Jersey, doth hereby certify that pursuant to and by virtue of title 14 of the Revised Statutes of the State of New Jersey it has voted to decrease the capital stock of the company from an authorized capital stock of $600,000, divided into 6,000 shares of the par value of $100.00 each, of which 5,914 shares are presently issued and outstanding, to $295,700, represented by 5,914 shares of capital stock without nominal or par value, the manner, terms and conditions of effecting said decrease being the issuance by the company, to the holders of the present capital stock, of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable semi-annually, on June 1st and December 1st in each year, and the principal whereof shall be payable in twenty years from the date thereof, plus 5,914 shares of the new common stock of the company without nominal or par value, in exchange for the shares of the present capital stock of the par value of $100.00 per share now held by them on the

Exhibit P-6.

basis of one $50.00 bond and one share of stock without nominal or par value for each share of the present capital stock surrendered, said decrease and the manner of effecting same and the terms and conditions thereof having been declared by resolution of the Board of Directors of said corporation (hereinbefore recited) to be advisable and having been duly and regularly assented to by the vote of at least two-thirds of the stockholders at a meeting duly called by the Board of Directors for that purpose; and the written assent of said stockholders is hereto appended.

In Witness Whereof, the said corporation has caused this certificate to be signed by its President and Secretary and its corporate seal to be hereto affixed, this 6th day of December, 1940.

Newark Theatre Building Corporation

By A. A. Adams
President

(Seal)

Martin W. D'Arcy
Secretary

State of New Jersey }
County of Essex } ss.:

Be It Remembered that on this 6th day of December, 1940, before me, the subscriber, a Notary Public of New Jersey, personally appeared Martin W. D'Arcy, Secretary of Newark Theatre Building Corporation, the corporation mentioned in and which executed the foregoing certificate, who, being by me duly sworn on his oath, says he is such Secretary, and that the seal affixed to said certificate is the corporate seal of said corporation, the same being well

Exhibit P-6.

known to him; that Adam A. Adams is President of said corporation and signed said certificate and affixed said seal thereto and delivered said certificate by authority of the Board of Directors and with the assent of at least two-thirds in interest of the stockholders of said corporation as and for his voluntary act and deed and the voluntary act and deed of said corporation in the presence of deponent, who thereupon subscribed his name thereto as witness.

And he further says that the assent hereto appended is signed by at least two-thirds in interest of the stockholders of said corporation, either in person or by their several duly constituted attorneys-in-fact thereunto duly authorized in writing.

MARTIN W. D'ARCY.

Subscribed and sworn to before me this 6th day of December, 1940.

HELEN CORDING
Notary Public of New Jersey

STOCKHOLDERS' ASSENT TO CHANGE.

We, the subscribers, being all of the stockholders of Newark Theatre Building Corporation, having at a meeting regularly called for the purpose, voted in favor of decreasing the capital stock from an authorized capital stock of $600,000, divided into 6,000 shares of the par value of $100.00 each, of which 5,914 shares are presently issued and outstanding, to $295,700, represented by 5,914 shares of capital stock without nominal or par value, the manner, terms and conditions of effecting said decrease being the issuance by the company, to the holders of the present capital stock,

Exhibit P-6.

of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable semi-annually, on June 1st and December 1st in each year, and the principal whereof shall be payable in twenty years from the date thereof, plus 5,914 shares of the new common stock of the company without nominal or par value, in exchange for the shares of the present capital stock of the par value of $100.00 per share now held by them on the basis of one $50.00 bond and one share of stock without nominal or par value for each share of the present capital stock surrendered, hereby give our written assent to said change.

WITNESS our hands and seals this 6th day of December, 1940.

Name		Number of Shares
A. A. ADAMS	(L. S.)	5903 shares
MARIE A. ADAMS	(L. S.)	ten shares
MARTIN W. D ARCY	(L. S.)	one share

Endorsed:

"Filed and Recorded Dec 10 1940
Thomas A. Mat[illegible],
Secretary of State."

Exhibit P-6.

STATE OF NEW JERSEY

Department of State

I, Thomas A. Mathis, Secretary of State of the State of New Jersey, do hereby certify that the foregoing is a true copy of Certificate of Decrease of Capital Stock and Amendment of Certificate of Incorporation of Newark Theatre Building Corporation, and the endorsements thereon, as the same is taken from and compared with the original filed in my office on the Tenth day of December, A. D. 1940, and now remaining on file and of record therein.

In Testimony Whereof, I have hereunto set my hand and affixed my Official Seal at Trenton, this Tenth day of December, A. D. 1940.

(Seal)

Thomas A. Mathis,
Secretary of State.

Exhibit P-7.

NEWARK THEATRE BUILDING CORP.
NEWARK, NEW JERSEY

BALANCE SHEET
AS AT: DECEMBER 31st, 1940

ASSETS

Real Estate:			
Land, 193-195 Market St.		$471,400.00	
Buildings	$472,935.00		
Less depreciation	245,926.20	227,008.80	
			$698,408.80
Land, 286-288 Market St.		108,000.00	
Building and improvements	91,214.88		
Less depreciation	44,333.41		
		46,881.47	
Equipment: Heating plant	718.72		
Less depreciation	479.13	239.59	
			155,121.06
Equipment:			
Theatre furniture and fixtures		61,703.37	
Less depreciation		56,230.87	
			5,472.50
Other:			
Cash in banks		$ 42,107.02	
Deposit a/c Gus Pappas		100.00	
Accrued interest receivable		77.81	
Unexpired insurance		503.66	
Rents receivable		635.00	
Notes receivable: Premier Amusement		41,500.00	
			84,923.49
Total assets			$943,925.85

Exhibit P-7.

LIABILITIES

Fixed:		
Mortgage payable, 286-288 Market St.	$ 60,000.00	
Mortgage payable, Prudential	231,250.00	
		$291,250.00
Accounts payable		1,031.75
Accruals:		
Federal capital stock tax	452.10	
Interest on mortgages	2,890.63	
Federal income and declared value excess profits tax	9,772.32	
		13,115.05
Total liabilities		$305,396.80

CAPITAL

Common stock	$591,400.00
Surplus: Donated surplus	1,500.00
Surplus	45,629.05
Total liabilities and capital	$943,925.85

Exhibit P-8.

NEWARK THEATRE BUILDING CORP.
NEWARK, NEW JERSEY

EXHIBIT "A"

BALANCE SHEET
AS AT: DECEMBER 31st, 1941

ASSETS

Real estate:			
Land: 193-195 Market St.		$471,400.00	
Buildings	$472,935.00		
Less depreciation	264,843.60	208,091.40	
			$679,491.40
Land: 286-288 Market St.		108,000.00	
Building and improvements	91,214.88		
Less depreciation	48,061.53	43,153.35	
Equipment: Heating plant	718.72		
Less depreciation	527.05	191.67	
			151,345.02
			830,836.42
Other:			
Cash in bank		44,537.88	
Deposit, Gus Pappas Agent (a/c)		100.00	
Unexpired insurance		2,224.58	
Rents receivable		2,354.58	
Notes receivable – (Premier Amusement Corp.)		38,000.00	
			87,217.04
Total assets			$918,053.46

Exhibit P-8.

LIABILITIES

Fixed:		
Mortgage payable, 286-288 Market St.	$ 56,000.00	
Mortgage payable, 193-195 Market St.	206,250.00	
		$262,250.00
Debentures payable		295,700.00
Current:		
Accounts payable	532.25	
Accrued taxes	281.25	
Accrued interest	4,056.63	
Reserve for Federal income tax (1940)	274.38	
Reserve for Federal income tax (1941)	4,840.13	
		9,984.64
Total liabilities		$567,934.64

CAPITAL

Common stock issued (5,914 shares N. P. V.)	$295,700.00
Surplus:	
Donated surplus	1,500.00
Net operating surplus	52,918.82
Total liabilities and capital	$918,053.46

Opinion.

THE TAX COURT OF THE UNITED STATES

ADAM A. ADAMS, PETITIONER,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

Docket No. 4109. Promulgated April 26, 1945.

Petitioner was the principal owner of the common stock of X corporation, which had no other class of stock and no bonds. Pursuant to a plan of recapitalization, petitioner exchanged his stock having a par value of $100 per share for new, no par value common stock having a stated value of $50 per share and 20-year debenture bonds of X bearing 6 per cent interest of a face amount equal to one-half of the par value of the old stock. No change was made in the surplus account of X and no declaration of a dividend was made. The purpose of the recapitalization was to minimize state franchise taxes and the Federal income tax liability of X. *Held*, recapitalization was for a legitimate business purpose and the debentures received by petitioner in the exchange did not constitute a taxable dividend.

Sydney A. Gutkin, Esq., for the petitioner.

Jonas M. Smith, Esq., for the respondent.

The Commissioner determined a deficiency in petitioner's income tax for the calendar year 1941 in the amount of $113,021.44.

Aside from one small item not in dispute, the deficiency results from respondent's finding that an exchange by petitioner of common stock of the Newark Theatre Building Corporation for new common stock and debenture bonds of

the same corporation in January 1941, in connection with a plan of recapitalization of that company, resulted in the distribution of a dividend to petitioner constituting fully taxable income.

The petitioner contends that the transaction was a recapitalization and reorganization within the meaning of section 112 of the Internal Revenue Code and was not a distribution of a dividend; and, in the alternative, he contends that there was a loss from the transaction rather than a gain; that if there was a gain, it was taxable as a capital gain; and that if it is to be treated as a dividend, it was a dividend of no value.

Since we are of the opinion that petitioner is correct in his primary contention, we consider it necessary to make findings of fact upon this issue only.

Findings of Fact.

Petitioner is an individual, residing in New Jersey, and he filed his income tax return for the calendar year 1941 with the collector of internal revenue for the fifth district of New Jersey.

He was the president and principal stockholder of the Newark Theatre Building Corporation, a New Jersey corporation. At the beginning of 1941 he owned 5,903 shares of a par value of $100 each, out of a total of 5,914 shares issued and outstanding. The authorized capital was 6,000 shares.

Petitioner and his brother were originally engaged in business together as partners. Later on they conducted their business affairs through corporations organized by them, and in connection with the financing of the Newark Theatre Building Corporation's operations both individuals guaranteed the indebtedness of that corporation secured by a mortgage on its property. In 1935 they divided their busi-

ness interests, and petitioner became the principal stockholder of the Newark corporation. Thereafter, his brother repeatedly demanded that he be relieved of his liability on the bonds. The Prudential Insurance Co., which held the mortgage, declined to release him, and petitioner foresaw the necessity of making other financial arrangements when the Prudential mortgage matured in 1941.

On December 6, 1940, the directors of the corporation met to consider the desirability of "revamping the capital structure of the company." The president pointed out that, in his opinion, the whole capital structure was not well balanced, and that it was not good business to have such a top-heavy capital set-up. He stated that a simple plan of recapitalization could be evolved which would bring about the desired change at comparatively little expense to the company; that he had consulted legal and accounting counsel, who could see no difficulty in consummating the plan of recapitalization.

The following plan was then proposed and adopted:

(1) A reduction in the authorized capital stock from $600,000 represented by 6,000 shares of a par value of $100 each, of which 5,914 shares, or $591,400 are issued and outstanding, to $295,700, to be divided into 5,914 shares without nominal or par value.

(2) The issuance of debenture bonds in the aggregate principal amount of $295,700, bearing interest at the rate of 6 percent per annum, payable semi-annually, the principal to be payable in 20 years from the date thereof, plus 5,914 shares of the new no par common stock, in exchange for the present shares of capital stock, on the basis of one $50 bond and one share of no-par value common stock for each of the present $100 par value shares surrendered.

The directors adopted the appropriate resolution to amend the certificate of incorporation to provide for the

reduction of authorized capital, and the issuance of no par value stock, and the stockholders duly ratified and approved the actions of the directors with respect thereto.

The purposes of the plan of recapitalization were: First, the saving of New Jersey franchise taxes in excess of $400 per year and, second, the reduction of the corporation's Federal income tax liability in substantial amounts each year by the deduction of the interest paid on the bonds.

The recapitalization was carried out in exact accordance with its terms. Petitioner surrendered his 5,903 shares of $100 par value stock, and received for each share thereof one share of no par value stock of a stated value of $50 and one $50 debenture bond. The bondholders were to rank *pari passu* with unsecured creditors in event of dissolution.

On the books of the corporation the old par capital stock account was debited with $591,400 and the new no par capital stock account was credited with $295,700, and the balance of $295,700 was credited to a "debentures payable" account. The surplus account was not affected.

Subsequently, petitioner gave to each of his two sons who worked with him in the business of the corporation debenture bonds of the face value of $24,000, or a total of slightly more than 16 per cent of his holdings.

The corporation's balance sheet as of December 31, 1940, was as follows:

ASSETS

Real Estate:			
Land, 193-195 Market St.		$471,400.00	
Buildings	$472,935.00		
Less depreciation	245,926.20	227,008.80	
			$698,408.80
Land, 286-288 Market St.		[illegible]	
Building and improvements	91,214.88		
Less depreciation	44,333.41		
		46,881.47	
Equipment: Heating plant	718.72		
Less depreciation	479.13	239.59	
			155,121.06

Equipment:		
Theatre furniture and fixtures	61,703.37	
Less depreciation	56,230.87	
		5,472.50
Other:		
Cash in banks	$ 42,107.02	
Deposit a/c Gus Pappas	100.00	
Accrued interest receivable	77.81	
Unexpired insurance	503.66	
Rents receivable	635.00	
Notes receivable: Premier Amusement	41,500.00	
		84,923.49
Total assets		$943,925.85

LIABILITIES

Fixed:		
Mortgage payable, 286-288 Market St.	$ 60,000.00	
Mortgage payable, Prudential	231,250.00	
		$291,250.00
Accounts payable		1,031.75
Accruals:		
Federal capital stock tax	452.10	
Interest on mortgages	2,890.63	
Federal income and declared value excess profits tax	9,772.32	
		13,115.05
Total liabilities		$305,396.80

CAPITAL

Common stock	$591,400.00
Surplus: Donated surplus	1,500.00
Surplus	45,629.05
Total liabilities and capital	$943,925.85

Opinion.

The balance sheet as of December 31, 1941, was as follows:

ASSETS

Real estate:			
Land: 193-195 Market St.		$471,400.00	
Buildings	$472,935.00		
Less depreciation	264,843.60	208,091.40	
			$679,491.40
Land: 286-288 Market St.		108,000.00	
Building and improvements	91,214.88		
Less depreciation	48,061.53		
		43,153.35	
Equipment: Heating plant	718.72		
Less depreciation	527.05	191.67	
			151,345.02
			830,836.42
Other:			
Cash in bank		44,537.88	
Deposit, Gus Pappas Agent (a/c)		100.00	
Unexpired insurance		2,224.58	
Rents receivable		2,354.58	
Notes receivable (Premier Amusement Corp.)		38,000.00	
			87,217.04
Total assets			$918,053.46

LIABILITIES

Fixed:			
Mortgage payable, 286-288 Market St.		$ 56,000.00	
Mortgage payable, 193-195 Market St.		206,250.00	
			$262,250.00
Debentures payable			295,700.00
Current:			
Accounts payable		532.25	
Accrued taxes		281.25	
Accrued interest		4,056.63	
Reserve for Federal income tax (1940)		274.38	
Reserve for Federal income tax (1941)		4,843.13	
			9,984.64
Total liabilities			$567,934.64

CAPITAL

Common stock issued (5,914 no par shares)	$295,700.00
Surplus:	
Donated surplus	1,500.00
Net operating surplus	52,948.82
Total liabilities and capital	$918,053.46

The earnings and profits of the corporation up to December 31, 1941, accumulated after February 28, 1913, were $164,874.47, some of which had been capitalized by stock dividends declared in prior years.

The recapitalization above described was for the financial benefit of the corporation and had a legitimate business purpose.

OPINION.

KERN, *Judge:* The respondent has determined and now contends that petitioner received a taxable dividend, as the result of the exchange of old common stock for new common stock and debenture bonds of the Newark Theatre Building Corporation, to the extent of the latter's accumulated earnings, in the amount of $164,208.82. Respondent relies upon section 115 (a) and (g) of the Internal Revenue Code.[1]

[1] (a) DEFINITION OF DIVIDEND.—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(g) REDEMPTION OF STOCK.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

Petitioner surrendered stock having a par value of $590,300, and received in exchange therefor stock having a stated value of $295,150 and debenture bonds of the face value of $295,150. The corporate surplus remained untouched. The authorized capital was reduced to $295,700, and the balance of $295,700 formerly carried in the capital stock account was transferred to an account for the payment of the debenture bonds. No dividend was declared.

Both parties have briefed their contentions upon the assumption that if there was a recapitalization amounting to a reorganization under section 112 (g) (1) (E) of the Internal Revenue Code and an exchange of stock for stock and securities under section 112 (b) (3), then there could not be by that fact itself a taxable dividend resulting from the transaction. Accordingly, respondent contends that the transaction was not a non-taxable reorganization since it was not for any business purpose; while the petitioner contends that it was a recapitalization effected for legitimate business purposes and, therefore, a reorganization upon which no gain or loss should be recognized.

As we pointed out in *Edith B. Bass*, 45 B. T. A. 1117, 1119, the issue in a case such as this is not whether there was a taxable gain resulting from an exchange, but whether petitioner received a taxable dividend. While this is a correct statement of the issue, it does not make irrelevant the question of whether there was, in reality, a recapitalization. The facts which would be relevant in proving or disproving the existence of a bona fide recapitalization under the reorganization provisions of the code would also be relevant in proving or disproving that the same transaction amounted to a distribution of a taxable dividend. If facts tended to show the actual accomplishment of a recapitalization having legitimate business purposes, those same facts would tend to prove that the transaction was not the distribution of dividend under section 115 (g). Thus, if a corpora-

tion decided, for its own legitimate business purposes, to make adjustments in its capital structure, and did so in order to accomplish those purposes, it would be difficult to conclude that the transaction was also a distribution equivalent to a dividend undertaken for the benefit of its stockholders. See *Jacob Fischer*, 46 B. T. A. 999, 1011; *Alice H. Bazley*, 4 T. C. 897.

With this conception of the ultimate issue in mind, we proceed to a consideration of the question whether the transaction constituted, in reality, a recapitalization effected by the corporation for a legitimate business purpose.

The disposition of this question requires an examination of the purposes of the reorganization, as outlined by petitioner.

The first of these, designated as the "principal" purpose, was a belief that the existence of debenture bonds, available for use as collateral would facilitate the refinancing of the corporation's mortgage indebtedness, then impending. Petitioner testified that he believed debenture bonds might be more acceptable than common stock if additional collateral were required in negotiating a new loan. The refinancing arrangements were successfully completed, but the record is completely silent as to whether the bonds were used in that connection. We may fairly assume, therefore, that they were not.

We are not impressed with the validity or the existence of this alleged purpose. It is difficult to see how debenture bonds of this nature, inferior to the mortgage lien itself, would have been as attractive to a mortgage bondholder of the corporation as common stock, which would at least have provided the creditor, already secured by a mortgage on the debtor's property, with some additional security in the form of a voice in the management of the corporation in event of default and pending foreclosure.

The second reason for the reorganization, according to petitioner, was his desire to give some securities of the corporation to his two sons, who were associated with him in the business of the corporation, without surrendering any of his stock control over the company. He did give them bonds of a total face value of $48,000, representing about 16 per cent of his holdings. This was obviously a personal reason having no connection with the corporate business.

The remaining two reasons may be considered together. They were the saving of corporate income tax resulting from the right to deduct interest paid on the bonds, and saving of New Jersey franchise tax resulting from the decrease in the amount of stock. The total amount of the savings to the corporation was not computed, but it is apparent they are and will be substantial in each of the corporation's future tax years during the life of the bonds.

Respondent attacks these purposes as insufficient. It is true that the courts have held that where a recapitalization serves no legitimate corporate purpose, but is undertaken solely for the individual benefit of the stockholders, an exchange of securities made pursuant thereto is not excepted from taxation. See *Arthur S. Kleeman*, 35 B. T. A. 17; *Gregory* v. *Helvering*, 293 U. S. 465; *Royal Marchet*, 32 B. T. A. 72; *Louis Wellhouse*, 3 T. C. 333. Where the sole purpose is to minimize the taxes of the corporation's stockholders this rule would be pertinent.

But this case may be sharply distinguished in the essential particular that here, the object sought was the minimizing of the taxes of the corporation itself. This situation can and must be distinguished from cases where the reorganization is designed for the individual benefit of the stockholders, without resulting benefit to the corporation. The purpose here was to so arrange the corporation's financial structure that its future tax liability would be reduced.

Opinion.

We have recognized as a legitimate corporate purpose the reduction of the corporation's liability for dividends on preferred stock. In *Annis Furs, Inc.*, 2 T. C. 1096, we considered the reduction of the corporation's periodic charge from 6½ per cent (the dividend on the preferred stock exchange for debenture bonds) to 6 per cent (the interest in the bonds) as a sufficient financial advantage to the corporation to serve as a legitimate business purpose.

The reduction or elimination of other items of expense, by legal methods, is not essentially different. Any reduction of expense results in increased profits, and the primary purpose of all commercial corporations is the realization of profit.

We have already recognized that a reduction in the tax liability of a corporation may constitute a legitimate business purpose of a reorganization under the statute. *Clarence J. Schoo*, 47 B. T. A. 459. In that case two of the three reasons given for the recapitalization there in issue had to do with reductions in tax liability. Yet we said in part in our opinion:

> There is nothing in the circumstances to invite the doctrine of *Gregory* v. *Helvering*, 293 U. S. 465. No transaction was impending which threatened a tax on any of the participants. The recapitalization is not a sham or an artificial detour around a taxable event. There is nothing to indicate that a devious form of corporate maneuvering was masquerading as a recapitalization in order to avoid a tax which would have been assessed if the transaction had been permitted to take its direct course.

See also *C. A. Monroe*, 39 B. T. A. 685; *Tower* v. *Commissioner*,—Fed. (2d)—(C. C. A., 6th Cir., 4/2/45).

There is no evidence, and no contention, that this exchange was not in fact made, that the old stock was not really canceled, or that the debenture bonds here do not represent a genuine indebtedness. The business of the corporation continued to be carried on. There is no element of unreality or sham apparent anywhere in the record. The

facts of *Gregory* v. *Helvering, supra,* bear so little resemblance to the facts of this case that the rule there announced is inapplicable here. It can not be considered as authority for any rule that a corporation may not rearrange its capital structure, in exact accordance with the statute, in such a way as to secure *for itself in the future* whatever benefits it may be entitled to under the existing tax laws.

The case of *Crown Cork International Corporation,* 4 T. C. 19, is distinguishable on its facts. There it was held that a purported sale of securities by a parent corporation to a wholly owned subsidiary for the purpose of realizing a loss for tax purposes was, in reality, no sale, but a sham. The controlling fact in that case was that the "vendor" so controlled the "vendee" that there was, in reality, no such final disposition of the securities transferred as to justify a conclusion that there was a sale which would give rise to a tax loss. If there had been a final disposition of the securities transferred, e. g., a transfer to a corporation in no way controlled by the transferor, a sale would have been recognized for tax purposes even though the sole purpose of making the sale on the part of the transferor was to enable it to take a deduction on account of a loss.

We conclude that there was in this case a bona fide recapitalization of the corporation accomplished for its benefit and having a legitimate business purpose; that the transaction here in question was undertaken for the purpose of effecting that recapitalization; and that it was not undertaken for the purpose of effecting the distribution of a dividend to the stockholders of the corporation.

Therefore, and upon a consideration of all of the facts disclosed by the record, we are of the opinion that respondent erred in his determination that the issuance of debenture bonds to petitioner constituted a taxable dividend.

Decision will be entered under Rule 50.

Opinion.

5 T. C. No. 40.

THE TAX COURT OF THE UNITED STATES

ADAM A. ADAMS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 4109. Promulgated June 29, 1945.

Debentures distributed to petitioner by corporation of which he was principal common stockholder in connection with elimination of old common stock and issuance of new without par value, *held*, on facts failing to show corporate business purpose for the transaction, to constitute a taxable dividend to the extent of their value and of the corporation's accumulated earnings, notwithstanding that surplus account remained unchanged on corporate books.

SYDNEY A. GUTKIN, ESQ., for the petitioner.

JONAS M. SMITH, ESQ., ESQ., for the respondent.

Respondent determined a deficiency in petitioner's income tax for the calendar year 1941 in the amount of $113,021.44.

Aside from one small item not in dispute the deficiency results from respondent's finding that an exchange by petitioner of common stock of the Newark Theatre Building Corporation for new common stock and debenture bonds of the same corporation in January, 1941, in connection with the plan of recapitalization of that company resulted in the distribution of a dividend to petitioner constituting fully taxable income.

The petitioner contends that the transaction was a recapitalization and reorganization within the meaning of

section 112 of the Internal Revenue Code and was not a distribution of a dividend; and, in the alternative, he contends that there was a loss from the transaction rather than a gain, that if there was a gain it was taxable as a capital gain, and that if it is to be treated as a dividend, it was a dividend of no value.

FINDINGS OF FACT.

Petitioner is an individual residing in New Jersey, and he filed his income tax return for the calendar year 1941 with the collector of internal revenue for the fifth district of New Jersey.

He was the president and principal stockholder of the Newark Theatre Building Corporation, a New Jersey corporation. On January 26, 1941, he owned 5,903 shares of a par value of $100 each, out of a total of 5,914 shares issued and outstanding. The authorized capital was 6,000 shares.

Petitioner and his brother were originally engaged in business together as partners. Later on, they conducted their business affairs through corporations organized by them, and in connection with the financing of the Newark Theatre Building Corporation's operation, both individuals guaranteed the indebtedness of that corporation secured by a mortgage on its property. In 1935, they divided their business interests, and petitioner became the principal stockholder of the Newark corporation. Thereafter, his brother repeatedly demanded that he be relieved of his liability on the bonds. The Prudential Insurance Co., which held the mortgage, declined to release him, and petitioner foresaw the necessity of making other financial arrangements when the Prudential mortgage matured in 1941.

On December 6, 1940, the directors of the corporation met to consider the desirability of "revamping the capital

structure of the company." The president pointed out that, in his opinion, the whole capital structure was not well balanced, and that it was not good business to have so top-heavy a capital set-up. He stated that a simple plan of recapitalization could be evolved which would bring about the desired change at comparatively little expense to the company; that he had consulted legal and accounting counsel, who could see no difficulty in consummating the plan of recapitalization.

The following plan was then proposed and adopted:

(1) A reduction in the authorized capital stock from $600,000 represented by 6,000 shares of a par value of $100 each, of which 5,914 shares, or $591,400 are issued and outstanding, to $295,700, to be divided into 5,914 shares without nominal or par value.

(2) The issuance of debenture bonds in the aggregate principal amount of $295,700, bearing interest at the rate of 6 per cent per annum, payable semi-annually, the principal to be payable in 20 years from the date thereof, plus 5,914 shares of the new no-par common stock, in exchange for the present shares of capital stock, on the basis of one $50 bond and one share of no-par value common stock for each of the present $100 par value shares surrendered.

The directors adopted the appropriate resolution to amend the certificate of incorporation to provide for the reduction of authorized capital, and the issuance of no-par value stock, and the stockholders duly ratified and approved the actions of the directors with respect thereto.

It was anticipated that there would be a saving of New Jersey franchise taxes in excess of $400 per year and a reduction of the corporation's Federal income tax liability in substantial amounts each year by the deduction of the interest paid on the bonds.

Opinion.

The recapitalization was carried out in exact accordance with its terms. Petitioner on January 27, 1941, surrendered his 5,903 shares of $100 par value stock, and received for each share thereof one share of no-par value stock of a stated value of $50, and one $50 debenture bond. The bondholders were to rank *pari passu* with unsecured creditors in event of dissolution.

On the books of the corporation, the old par capital stock account was debited with $591,400, and the new no-par capital stock account was credited with $295,700, and the balance of $295,700 was credited to a "Debenture Payable" account. The surplus account was not affected.

Subsequently, petitioner gave to each of his two sons who worked with him in the business of the corporation debenture bonds of the face value of $24,000, or a total of slightly more than 16 per cent of his holdings. He duly reported these transfers for gift tax purposes and attributed to the bonds their full face value, paying gift tax thereon.

The corporation's balance sheet as of December 31, 1940, was as follows:

	ASSETS		
Real Estate:			
Land, 193-195 Market St.		$471,400.00	
Buildings	$472,535.00		
Less depreciation	245,926.20	227,008.80	
			$698,408.80
Land, 286-288 Market St.		108,000.00	
Building and improvements	91,214.88		
Less depreciation	44,333.41		
		46,881.47	
Equipment: Heating plant	718.72		
Less depreciation	479.13	239.59	
			155,121.06

Equipment:		
Theatre furniture and fixtures	61,703.37	
Less depreciation	56,230.87	
		5,472.50
Other:		
Cash in banks	$ 42,107.02	
Deposit a/c Gus Pappas	100.00	
Accrued interest receivable	77.81	
Unexpired insurance	503.66	
Rents receivable	635.00	
Notes receivable: Premier Amusement	41,500.00	
		84,923.49
Total assets		$943,925.85

LIABILITIES

Fixed:		
Mortgage payable, 286-288 Market St.	$ 60,000.00	
Mortgage payable, Prudential	231,250.00	
		$291,250.00
Accounts payable		1,031.75
Accruals:		
Federal capital stock tax	452.10	
Interest on mortgages	2,890.63	
Federal income and declared value excess profits tax	9,772.32	
		13,115.05
Total liabilities		$305,396.80

CAPITAL

Common stock	$591,400.00
Surplus—Donated surplus	1,500.00
Surplus	45,629.05
Total liabilities and capital	$943,925.85

Opinion.

The balance sheet as of December 31, 1941, was as follows:

ASSETS

Real estate:			
Land: 193-195 Market St.		$471,400.00	
Buildings	$472,935.00		
Less depreciation	264,843.60	208,091.40	
			$679,491.40
Land: 286-288 Market St.		108,000.00	
Building and improvements	91,214.88		
Less depreciation	48,061.53		
		43,153.35	
Equipment: Heating plant	718.72		
Less depreciation	527.05	191.67	
			151,345.02
			830,836.42
Other:			
Cash in bank		44,537.88	
Deposit, Gus Pappas Agent (a/c)		100.00	
Unexpired insurance		2,224.58	
Rents receivable		2,354.58	
Notes receivable (Premier Amusement Corp.)		38,000.00	
			87,217.04
Total assets			$918,053.46

LIABILITIES

Fixed:			
Mortgage payable, 286-288 Market St.		$ 56,000.00	
Mortgage payable, 193-195 Market St.		206,250.00	
			$262,250.00
Debentures payable			29,700.00

Current:		
Accounts payable	532.25	
Accrued taxes	281.25	
Accrued interest	4,056.63	
Reserve for Federal income tax (1940)	274.38	
Reserve for Federal income tax (1941)	4,840.13	
		9,984.64
Total liabilities		$567,934.64

CAPITAL

Common stock issued (5,914 shares N. P. V.)	$295,700.00
Surplus:	
Donated surplus	1,500.00
Net operating surplus	52,918.82
Total liabilities and capital	$918,053.46

The earnings and profits of the corporation accumulated since February 28, 1913, and up to December 31, 1940, were $157,225.05, and up to December 31, 1941, were $164,874.47, of which $111,596 had been capitalized by stock dividends declared in prior years. The accumulated earnings and profits of the corporation available for distribution on January 26, 1941, were not less than $164,514.82.

The debentures regularly earned and paid the interest due on them.

The debentures received by petitioner had a value when received of not less than $164,208.82.

The recapitalization and distribution of debentures above described had no legitimate business purpose.

OPINION.

OPPER, *Judge:*

An opinion in this proceeding was promulgated on April 26, 1945, (4 T. C. No. 140) which, pursuant to subse-

quent order, was referred to the Court for review and which is to be considered superseded by the present opinion.

As in *Alice H. Bazley, et al.*, 4 T. C. 897, the first question for disposition here is whether the non-recognition provisions of section 112 are applicable to the receipt by petitioner of debentures in a transaction involving the cancellation of previously outstanding common stock and the issuance of new no-par common. This in turn depends upon whether we can find as a fact that there was a legitimate purpose of the corporate business for the distribution to petitioner of the debentures.

The resolution of this problem requires an examination of the purposes of the "reorganization," as presented by petitioner. The first of these, designated as the "principal" purpose, was a belief that the existence of debenture bonds, available for use as collateral, would facilitate the refinancing of the corporation's mortgage indebtedness, then impending. Petitioner testified that he believed debenture bonds might be more acceptable than common stock if additional collateral were required in negotiating a new loan. The refinancing arrangements were successfully concluded, but the record is completely silent as to whether the bonds were used in that connection. We may fairly assume, therefore, that they were not.

We are not impressed with the validity or the existence of this alleged purpose. It is difficult to see how debenture bonds of this nature, inferior to the mortgage lien itself, would have been as attractive to a mortgage bondholder of the corporation as common stock, which would at least have provided the creditor, already secured by a mortgage on the debtor's property, with some additional security in the form of a voice in the management of the corporation in the event of default and pending foreclosure.

The second reason for the "reorganization," according to petitioner, was his desire to give some securities of the

corporation to his two sons, who were associated with him in the business of the corporation, without surrendering any of his stock control over the company. He did give them bonds of a total face value of $48,000, representing about 16 per cent of his holdings. This was obviously a personal reason having no connection with the corporate business.

The remaining two reasons may be considered together. They were the saving of corporate income tax resulting from the right to deduct interest paid on the bonds, and the saving of New Jersey franchise tax resulting from the decrease in the amount of stock. These purposes are equally unavailable when considered from the standpoint of the corporate business. As a result of the procedure adopted, the corporation undertook an annual obligation of 6 per cent of $295,150 in interest charges in order to secure the reduction of a few hundred dollars in state franchise taxes and of an indeterminate amount of Federal income tax which would necessarily be less than the interest obligation. If the money were to be borrowed from strangers, it seems evident that this could not but be a losing transaction for the corporation. As we said in *De Nobili Cigar Co.*, 1 T. C. 673, 679, affirmed (C. C. A., 2nd Cir.), 143 Fed. (2d) 436:

> * * * no explanation is offered why it was necessary, or even sound policy from the corporation's point of view, to capitalize earnings * * * and thus to pay 6 per cent for the use of funds which petitioner [the corporation] was already free to use * * *

See *Talbot Mills*, 3 T. C. 95, affirmed (C. C. A., 1st Cir.), 146 Fed. (2) 809, certiorari granted, U. S. (April 30, 1945).

That the dominant stockholder rather than a stranger happened to be the person to whom the interest would be

paid can account for the company so conducting itself in spite of the disadvantage to it. But while furnishing an explanation for the action, it offers no evidence of any independent benefit to the corporation itself as distinguished from the reciprocal advantage to petitioner as an individual from the receipt of the interest payments, and thus falls short of constituting the corporate business purpose which we are required to find in such cases. *Gregory* v. *Helvering*, 293 U. S. 465; *Alice H. Bazley, supra.*

Once the transaction is removed, as we accordingly think it must be, from the scope of section 112, a distribution of the corporation's debentures can partake of the nature of a taxable dividend to the same extent as any other distribution of property or of the stock of a wholly different corporation. *Doerschuck* v. *United States* (D. C. E. D. N. Y.), 274 Fed. 739; see *Peabody* v. *Eisner*, 247 U. S. 347. Our inquiry is then directed to whether under the provisions of section 115 (g) the distribution was essentially equivalent to a taxable dividend. *Edith B. Bass*, 45 B. T. A. 1117, reversed (C. C. A., 1st Cir., 129 Fed. (2d) 300. The contention is made that because the corporation's book surplus was undisturbed there could have been no dividend distribution.[1] For that position, to be sure, the reversal in *Edith B. Bass, supra*, can be cited as at least partial authority. With the greatest deference, however, we remain of the opinion that the decision of the Board of Tax Appeals in that case was correct, and we feel obliged to adhere to it rather than to follow the reasoning of the opinion of reversal.

The argument that by a bookkeeping entry purporting to make a distribution from capital and without disturbing earned surplus a corporation can be held to have accomplished that result seems to us to lose sight of the express

[1] A similar argument was made in *Alice H. Bazley, supra*, but we found it unnecessary to deal with it under the facts there brought forth.

statutory provision and to treat as cause what is in reality effect. Except for a distribution in liquidation, we must start with the premise that "every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits" because the statute so commands in unmistakable language.[2] We do not understand there is any suggestion that these were distributions in liquidation and nothing in the record warrants the assumption that they were. Internal Revenue Code, section 115 (c) and (i). If as a consequence there were earnings and profits, the distribution was a dividend or its essential equivalent, and the effect upon the corporation's earned surplus for purposes of future tax computation would be to reduce it regardless of the treatment of that surplus on the corporation's books. Cf. *Commissioner* v. *Bedford Estate*, U. S. (May 21, 1945); *August Hormann*, 34 B. T. A. 1178. "* * * 'earnings and profits' in the tax sense although it does not correspond exactly to taxable income does not necessarily follow corporate accounting concepts either." *Wheeler* v. *Commissioner*, U. S. (March 26, 1945). We are accordingly unable to agree that the mere dealing with the capital account in such a way that the distribution is treated on the corporate books as a diminution of capital rather than of earned surplus can have any binding influence on the determination which we are required to make. That is the effect of *Edith B. Bass*, *supra*, where we said, page 1121:

---

[2] Internal Revenue Code section 115(b)

"(b) SOURCE OF DISTRIBUTIONS.—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated or increase in value of property accrued before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113."

Opinion.

> * * * The issuance of the preferred stock in the present case gave to the recipients an interest different from that represented by their former stockholdings. That was the intent and purpose of the change. The corporation had more than sufficient earnings accumulated after February 28, 1913, to pay a dividend equal to the value of this preferred stock. The petitioner concedes that the issuance of stock involving the capitalization of earnings could result in a taxable dividend, but contends that this was a "split-up" involving merely a change in the character and number of shares by which existing capital continued to be represented and was not a taxable dividend. It is immaterial that the corporation did not capitalize any earnings to support the issuance of the preferred stock, since section 115 (b) provides that "every distribution is made out of earnings or profits to the extent thereof." * * *

This statement seems warranted by the observation in *Helvering* v. *Gowran*, 302 U. S. 238, that

> * * * under section 115 (b) * * * (the distribution of preferred stock) was presumed to have been made "out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits." In no sense, therefore, can it be said to have been "held" by Gowran prior to its declaration. Since the proceeds were therefore not "capital gains" they were taxable at the normal and surtax rates applicable to ordinary income.

Having found, as we think we must, that such earnings as the corporation had were distributed by means of the debentures to the extent of their value, it becomes neces-

sary to examine the amount of those earnings and the fair market value of the debentures. The outer limit of taxability in that event will be the fair market value of the property received[3] under section 115 (j) and the amount of earnings and profits of the corporation available for distribution[4] under section 115 (a). On the first subject it is conceded that the corporation had undistributed earnings as of the close of the year 1940 of $45,629.05. In addition there had been deductions from earned surplus on account of the distribution of prior nontaxable stock dividends in the amount of $111,596, which must be added to the corporate earnings available for distribution. *August Horrmann, supra.* The distribution was not made on December 31, 1940, however, but on January 26, 1941. There is no evidence whatever from which we can determine what earnings and profits were available on that date. Respondent has found them to be a figure somewhat, though slightly, less than the amount shown on the balance sheet as of the end of the current year. Under the circumstances we cannot say that petitioner has sustained his burden of proving that respondent's determination was erroneous in this respect. *Dorothy Whitney Elmhirst*, 41 B. T. A. 348, 354-360.

Similarly, the fair market value of the debentures is in effect conceded to be their face amount, although petitioner

---

[3] Internal Revenue Code, section 115(j).

"(j) VALUATION OF DIVIDEND.—If the whole or any part of a dividend is paid to a shareholder in any medium other than money, the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder."

[4] Internal Revenue Code, section 115(a).

"(a) DEFINITION OF DIVIDEND.—The term 'dividend' when used in this chapter (except in section 203(a)(3) and section 207(c)(1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made."

contends that the common stock was thereby reduced drastically below its original basis to him. But the debentures carried interest which has been duly met, and were a claim to corporate assets which took preference over that of the stockholders. To say nothing of petitioner's own contemporaneous gift tax valuation, the corporate assets, even at petitioner's present figure, are sufficient to justify our finding of the value of the debentures from the standpoint of collectibility upon default. Although these figures are strenuously contested by respondent, who insists that the corporate assets were of sufficient value to cover both the debentures and petitioner's original basis for the stock, we are mindful that this is not a gain or loss situation and requires no determination as to the value of the stock. *Edith B. Bass, supra,* refers to the

> * * * opinions in *United States* v. *Phellis*, 257 U. S. 156, and *Rockefeller* v. *United States*, 257 U. S. 176, in which the Court had said that the test of taxability of a corporate distribution lies in its effect upon the individual stockholder rather than upon the corporation or the stockholders as a group, and it does not matter that the value of the stock on which the distribution was made was thereby decreased. The normal result of declaring a dividend of any kind is to reduce the value of stock theretofore outstanding. * * *

If the debentures were worth at least as much as the corporation's earned surplus, which they undoubtedly were, respondent's determination must be sustained and any further discussion is beyond the necessary confines of the present question. In the light of those circumstances we have found as a fact only that the fair market value of the debentures was at least as great as the dividend determined

by respondent to have been received. It follows that respondent's determination must be sustained in the amount found by him.

Reviewed by the Court.

Decision will be entered for the respondent.

KERN, *J.*, dissenting:

A reduction in the tax liability of a corporation may constitute a legitimate business purpose of a reorganization under the statute. *Clarence J. Schoo*, 47 B. T. A. 459. See also, *C. A. Monroe*, 39 B. T. A. 685; *Toner v. Commissioner*, Fed. (2) , (CCA-6, April 2, 1945). A reduction in the corporation's liability for dividends or interest also constitutes a legitimate business purpose. *Annis Furs, Inc.*, 2 T. C. 1096. However, the majority opinion holds that where the reduction in the corporation's tax liability is accompanied by an increase in liability for interest in an equal or greater amount, the reduction in tax liability cannot be said to be a legitimate business purpose.

With this I am unable to agree. A realistic view of the ultimate purpose of a private corporation is that it is to make money for the investors who have contributed their capital to it, and to distribute to them as much as possible and practical out of its gross income. Under the facts of the instant case, it is apparent that after the recapitalization in question, petitioner, as an investor of the corporation, would receive a greater distribution of money in the form of dividends and interest than he received as dividends before the recapitalization. Therefore, the recapitalization contributed to the business purpose of the corporation and must be considered as a legitimate business purpose.

Since, in my opinion, the adjustments made by the corporation in its capital structure were for the purpose of

accomplishing a legitimate business purpose, I am unable to conclude that the transaction was also a distribution equivalent to a dividend. See *Jacob Fisker*, 46 B. T. A. 1011.

SMITH, *J.*, agrees with this dissent.

ARUNDELL, *J.*, dissenting:

It was my understanding that the so-called corporate reorganization provisions of the revenue acts were designed to permit some flexibility in the financial set-up of corporations without the present imposition of a tax due to such changes. It was recognized that our capitalistic economy could not properly function if it was kept in a strait-jacket, as it most surely would be if a tax consequence resulted with every change in the financial structure. Thus, recapitalizations were permitted without the present recognition of tax, leaving the imposition of the tax to the time when the exchanged security should be finally disposed of. No one contends that if the recapitalization is, in fact, a fraud or a sham it is to be recognized, but I do not understand the majority would characterize what has taken place as falling within either category. Debenture bonds have taken the place of common stock and that change in capitalization was what the directors desired and that is what they accomplished. There has been a permanent change in the capital structure, and it is the receipt of these very debentures by a stockholder which, the majority hold, constitutes a taxable dividend.

But, it is said that there was no "legitimate" reason for this recapitalization. Certainly what was done was legitimate in the sense that it was lawful. Many corporations are originally organized in the same way that this corporation was "reorganized"; and if it had been initially capi-

talized in the identical way that it is today, it would be subject to no criticism. Surely it was never intended that the tax collector or, indeed, a member of this court should pass on the wisdom or desirability of a corporate recapitalization. If what was done here was genuine and was not a sham, the test of the statute has been met. I think *Buss v. Commissioner*, 129 Fed. (2d) 308, supports the view here expressed.

SMITH, BLACK, HILL and KERN, *JJ.*, agree with this dissent.

Decision.

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion, promulgated June 29, 1945, it is ORDERED and DECIDED: That there is a deficiency in income tax of $113,021.44 for the calendar year 1941.

Entered June 29, 1945.

(Signed) CLARENCE V. OPPER,
Judge.

(Seal)

Proceedings.

IN THE

UNITED STATES CIRCUIT COURT OF APPEALS.

FOR THE THIRD CIRCUIT.

No. 9069 October Term, 1945.

ADAM A. ADAMS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

And afterwards, to wit, 7th day of February, 1946, come the parties aforesaid by their counsel aforesaid, and this case, being called for argument sur pleadings and briefs, before the Honorable Albert B. Maris, Honorable Herbert F. Goodrich and Honorable John J. O'Connell, Circuit Judges, and the Court not being fully advised in the premises, takes further time for the consideration thereof.

Order.

UNITED STATES CIRCUIT COURT OF APPEALS.

FOR THE THIRD CIRCUIT.

No. 9069.

ADAM A. ADAMS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Present: MARIS, McLAUGHLIN and O'CONNELL, Circuit Judges.

It is hereby ORDERED that the above entitled case be restored to the argument list for the current term for reargument before the court *en banc*.

By the Court,

MARIS,
Circuit Judge.

February 15, 1946.

Endorsements—

Order Restoring Case to Argument List for Reargument before the Court *en banc*.
Received & Filed Feb. 15, 1946,
Wm. P. Rowland, Clerk.

Opinion of the Court.

(Filed April 16, 1946).

UNITED STATES CIRCUIT COURT OF APPEALS.

FOR THE THIRD CIRCUIT.

No. 9969 October Term, 1945.

ADAM A. ADAMS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

ON APPEAL FROM DECISION OF THE TAX COURT OF THE UNITED STATES.

Argued February 7, 1946.

Reargued March 5, 1946.

Before BIGGS, MARIS, GOODRICH, McLAUGHLIN and O'CONNELL, *Circuit Judges*.

By O'CONNELL, *Circuit Judge*.

Basically, this case presents the same issues as *Bazley v. Commissioner*, C. C. A. 3, April 1946. There are two factual differences, however, which call for further consideration. As in Bazley, we have before us a petitioner who is the principal shareholder[1] of a tightly held corporation.

The taxpayer, in connection with the elimination of old common stock and the issuance of new without par value,

[1] Petitioner held 5,993 out of a total of 5,914 shares outstanding. The authorized capital was 6,000 shares of $100 par value.

received debentures distributed by the corporation.[2] The bonds were worth not less than $164,208.82, and regularly earned and paid the interest due on them. At the time of their distribution, the corporation had accumulated earnings and profits since February 28, 1913, in a sum at least equal to $164,514.82.[3] The corporate books showed no change in its surplus account following or as a result of the distribution of the bonds.[4]

The Tax Court found there was no legitimate reorganization within the meaning of the Revenue Code, Section 112,[5] and that this was a distribution "essentially equivalent to a taxable dividend"; Section 115 (g).[6]

Both conclusions are challenged. We are urged to reverse the Tax Court on the ground that there is here a legitimate reorganization because it was undertaken to save an annual New Jersey franchise tax in the amount of $400 and achieve a saving in corporate income tax resulting from the right to deduct interest paid on the bonds. The Tax Court took a rather skeptical view of these so-called reasons for the reorganization, pointing out the obvious financial disadvantage to the corporation in agreeing to pay a huge interest charge on almost $300,000 worth of debenture

[2] The following "plan of reorganization" was consummated: (1) A reduction in authorized capital stock from $600,000 represented by 6,000 shares of a par value of $100 each, of which 5,914 shares of $591,400 were issued and outstanding, to $295,700, to be divided into 5,914 shares without nominal or par value. (2) The issuance of debenture bonds in the aggregate principal amount of $295,700, bearing interest at the rate of 6 per cent per annum, payable semi-annually, the principal to be payable 20 years from the date thereof, plus 5,914 shares of the new no-par common stock, on the basis of one $50 bond and one share of no-par value common stock for each of the present $100 par value shares surrendered. There was compliance with the provisions of the New Jersey law regarding such corporate transactions.

[3] $111,596 had been capitalized by stock dividends declared in prior years.

[4] The old par capital stock account was debited with $591,400 and the new no par capital stock account was credited with $295,700, and the balance of $295,700 was credited to a "Debenture Payable" account. The surplus account was not affected.

[5] 26 U. S. C. (1940 ed.) Sec. 112; 26 U. S. C. A. Sec. 112

[6] 26 U. S. C. (1940 ed.) Sec. 115 (g); 26 U. S. C. A. Sec. 115 (g).

bonds to achieve a reduction in corporate tax liability of a much lesser sum. It concluded that the "recapitalization" and distribution of debentures" by the corporation "had no legitimate business purpose."

We agree with this conclusion. In *Bazley*, we pointed out that Congress did not intend to exempt all "reorganizations" from tax consequences. Only those "required by business exigencies" or "undertaken for reasons germane to the continuance of the corporation" allegedly reorganized may qualify for the exemption.[7] The intent of Congress in allowing Section 112 to remain in the 1934 Revenue Act was to permit, tax free, "legitimate reorganizations required in order to strengthen the financial condition of the corporation. * * *"[8] In the light of these requirements, we believe the Tax Court, applying the proper criterion, reached the correct conclusion. This was not the kind of corporate reorganization which Congress intended to make tax free.

We come now to the second point of departure. The precise question is whether the Tax Court's conclusion that this was a distribution essentially equivalent to a distribution of a taxable dividend may stand in view of the absence of a corresponding reduction in the surplus account. In determining tax liability, bookkeeping entries are not necessarily conclusive. Income tax liability does not stand or fall with the particular method adopted by corporate accountants in reflecting transactions under scrutiny. Here again, actions count. What was accomplished by the transaction? The Tax Court inquired and found that what appears to be a distribution out of capital is in reality made out of accumulated earnings and profits. If over the years since February 28, 1913, the corporation piled up earnings

[7] Treasury Regulations 103, Sec. 19.112 (g)-1, Sec. 19.112 (g)-2.

[8] See Report by Chairman Doughton of the House Ways and Means Committee, accompanying the submission of the Revenue Act of 1934 (H. No. 704, 73d Cong., Second Session).

and, *qua bookkeeping*, imprisoned them in the capital account through the issuance of non-taxable stock dividends,[9] a subsequent distribution in money or bonds of an amount not in excess of such accumulated earnings and profits can partake of the quality of a dividend distribution: Section 115 (b),[10] "every distribution is made out of earnings or profits to the extent thereof." Corporate accounting concepts are not controlling: *Commissioner* v. *Estate of Bedford*, 325 U. S. 283 (1945); *Commissioner* v. *Wheeler*, 324 U. S. 542 (1945); *cf. Helvering* v. *Gowran*, 302 U. S. 238 (1937).

Once it is concluded that the debentures were distributed out of earnings or profits accumulated since February 28, 1913, taxation must result. To hold otherwise would be to permit, by means of bookkeeping entries, the use of the Section 112 exemption as a device to evade the payment of income tax as required under Section 115: *cf. Commissioner* v. *Fisher*, U. S. Sup. Ct., March 11, 1946.

In the last analysis, this case turns on a dispute over proper accounting procedure for income tax collection purposes. We are not at liberty to treat as a question of law such a dispute. It is patently controlled by the Dobson rule.

Affirmed.

MARIS and GOODRICH, *Circuit Judges*, dissenting.

Maris and Goodrich, Circuit Judges, dissent for the reason set out in their dissenting opinion in the case of *Bazley* v. *Commissioner*, ... F. (2d) ...

[9] *Cf. Helvering* v. *Griffiths*, 318 U. S. 371 (1943).

[10] 26 U. S. C. (1940 ed.) Sec. 115 (b); 26 U. S. C. A. Sec. 115 (b).

A true Copy:

Teste:

Clerk of the United States Circuit Courts of Appeals for the Third Circuit.

Judgment.

IN THE

UNITED STATES CIRCUIT COURT OF APPEALS.

FOR THE THIRD CIRCUIT.

No. 9069 October Term, 1945.

ADAM A. ADAMS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Present: BIGGS, MARIS, GOODRICH, McLAUGHLIN and O'CONNELL, *Circuit Judges*.

Appeal from the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

By the Court,

JOHN J. O'CONNELL,
Circuit Judge.

April 16, 1946.

Endorsements—

Order Affirming Decision of the Tax Court.
Received & Filed April 16, 1946,
Wm. P. Rowland, Clerk.

Certificate.

UNITED STATES OF AMERICA,
Eastern District of Pennsylvania,
Third Judicial Circuit.

I, WM. P. ROWLAND, Clerk of the United States Circuit Court of Appeals for the Third Circuit, DO HEREBY CERTIFY the foregoing to be a true and faithful copy of the original Appendix to Petitioner's Brief, as constituting the portions of the record before this court at argument; and proceedings in this court, in the case of Adam A. Adams, Petitioner, vs. Commissioner of Internal Revenue, Respondent, No. 9069, on file, and now remaining among the records of the said Court, in my office.

IN TESTIMONY WHEREOF, I have hereunto subscribed my name and affixed the seal of the said Court, at Philadelphia, this 15th day of May in the year of our Lord one thousand nine hundred and forty six, and of the Independence of the United States the one hundred and seventieth.

(S) WM. P. ROWLAND,
Clerk of the U. S. Circuit Court of Appeals,
Third Circuit.

(Seal)

SUPREME COURT OF THE UNITED STATES, OCTOBER TERM, 1946

No. 269

ORDER ALLOWING CERTIORARI—Filed October 14, 1946

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Third Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.